FOREIGN OWNERSHIP AND THE STRUCTURE OF
CANADIAN INDUSTRY

Report of the Task Force on the
Structure of Canadian Industry

January 1968

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Ottawa

January 12, 1968.

The Honourable Walter L. Gordon
President of the Privy Council
Ottawa, Canada.

Dear Mr. Gordon:

It is my pleasure to transmit to you the Report of the Task Force on the Structure of Canadian Industry entitled "Foreign Ownership and the Structure of Canadian Industry".

My colleagues on the Task Force included Professors Bernard Bonin, Stephen H. Hymer, Claude Masson, Gideon Rosenbluth, Abraham Rotstein, A.E. Safarian and William J. Woodfine. I am pleased to inform you that the Report represents a consensus of our views. We regret that Professors Rosenbluth and Woodfine were unable to assist with the final draft because of prior academic commitments, although they indicated their agreement with our approach and conclusions.

Our debt is substantial to the many people who helped at various stages of the Project. Special studies were undertaken by research associates and a number of assistants. Many government officials gave us excellent cooperation and we are particularly indebted to the Advisory Committee of Senior Officials. Officials of foreign governments were generous with their time. Our secretaries were proficient throughout. None of the foregoing should be held responsible for the errors or omissions which may remain, nor for the contents of our Report.

May I say, finally, that it is our hope that research areas which we have initiated will be pursued further by the Government.

Respectfully submitted,

Melville H. Watkins

Melville H. Watkins
Head of the Task Force

Task Force on the Structure of Canadian Industry

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I. INTRODUCTION

i. Issue

1. The extent of foreign control of Canadian industry is unique among the industrialized nations of the world. Canadians are aware of the economic benefits which have resulted from foreign investment. They are also concerned about the implications of the present level of foreign control for Canada's long-run prospects for national independence and economic growth.

2. National economies are becoming increasingly interdependent. A world economy may yet become a reality. Canadians have a vital stake in these developments. Canada needs to attract and absorb capital and technology from abroad and to gain access to foreign markets. In the past, Canada has relied heavily on foreign direct investment to meet these necessities. This will continue. But there are other options as well, and more use could be made of these in the future. It is possible, to some extent, to acquire capital and technology without relinquishing control. It is important to devise national

policies which will increase the benefits and decrease the costs of foreign investment.

3. The multi-national corporation is a growing feature of the embryonic world economy. Many industries, including those based on the new technologies, are characterized by large corporations whose operations span the globe. This international business integration adds new dimensions to national policies. Canadians are concerned that these corporations be truly multi-national, genuinely respecting Canadian aspirations, and that Canada's national policies ensure that their behaviour is fully consistent with Canadian goals.

4. It is the intent of this Report to analyze the causes and consequences of foreign investment, to assess actual benefits and costs, and to put forth proposals for legislative consideration.

ii. <u>National Goals</u>

1. Two of the goals uppermost in the minds of Canadians today are national independence and a rising standard of living.

2. While recognizing the steady shrinking of the globe, it is important for Canada to maintain that degree of national independence necessary to undertake Canadian initiatives at home and abroad. Thereby, Canadian objectives can be pursued and the possibilities of self-assertion as a people enhanced.

3. The maintenance of steady economic growth, accompanied by an equitable distribution of income among regions and classes, is necessary to raise living standards generally and to provide job opportunities for an expanding labour force.

4. Maintaining national independence will increase the capacity of the Canadian economy, by both private and public initiatives, to grow and develop in ways determined by Canadians. Maintaining steady economic growth will increase the extent to which Canadians can pursue distinctive national and international policies.

5. Our Centennial has highlighted a national independence achieved by the activities of citizens and the policies of government. As our second century begins, new national policies are required to sustain that independence and enhance the welfare of the Canadian people.

iii. Present Situation

1. In describing the significance of foreign capital in the Canadian economy, it would be useful to know what proportion of our total wealth is owned and controlled by foreigners. Because of statistical difficulties encountered in evaluating social capital, and in evaluating the assets employed in agriculture and certain services, this estimation cannot easily be done. Attention will be focused upon those capital flows and industries for which official statistical information is available. These paint an approximate but revealing picture of where we have been and where we are today as a result of foreign investment in Canadian economic activity.

2. In 1964, foreigners owned $33 billion worth of assets in Canada, while Canadians owned $13 billion of assets abroad. Canada's balance of international indebtedness was therefore $20 billion; this compares with a postwar low of $4 billion in 1949. Since, over the same period, gross national product has risen from $16 billion to $47 billion, the percentage increase in net foreign debt

has exceeded that of aggregate Canadian output. The major contributor to this increased indebtedness was the expansion in foreign long-term investments in Canada, which rose from $7 billion in 1945 to $27 billion in 1964.

3. The most significant increase in foreign long-term investment was in foreign direct investment. These, which are the primary concern of this Report, grew from $2.7 billion, or about 40 per cent of foreign long-term investment, in 1945 to $15.9 billion, or about 60 per cent of foreign long-term investment, in 1964. Of this $15.9 billion, United States direct investment accounted for $12.9 billion or 80 per cent while residents of the United Kingdom accounted for an additional $1.9 billion or 12 per cent. The value of company assets controlled abroad is higher, since these figures represent only the part financed abroad.

4. Although direct investments accounted for most of the increase in foreign capital since 1945, in 1963 and 1964 direct investments grew less rapidly than in earlier years while portfolio investments grew more rapidly. This was largely a result of sales of new bond issues

in the United States by provincial governments and municipalities. The sale of corporate bonds to non-residents also increased, while the federal government continued to sell almost all of its securities to Canadians. Non-resident ownership of Canadian long-term funded debt (excluding sinking funds) increased from $3.8 billion in 1954 to $8.2 billion in 1964, about one-third of which represented investment by United States insurance companies. In sum, non-residents owned 19 per cent of all Canadian funded debt in 1964; the United States alone accounted for 16 points of this 19 per cent.

5. As a result of the increase of direct and portfolio investments, the payments of interest and dividends to foreigners have risen substantially in absolute terms to more than $1 billion a year in recent years. Such payments abroad as a percentage of gross national product, however, have declined from 2.9 per cent in the late 1920's and 6.4 per cent in the depressed 1930's to 1.9 per cent in 1957-65. As a percentage of the earnings available from foreign sales of goods and service, payments abroad of interest and dividends have fallen from 16 per cent in the late 1920's and 25 per cent in

the 1930's to 9 per cent in 1957-65. These payments of income include those by both resident-controlled and non-resident-controlled firms.

6. Payments to foreigners for business services (such as management fees, royalties, franchises, advertising, rent, professional services, annuities and insurance) are one of the direct effects of non-resident investment in Canada. Unfortunately, statistics on these payments have not been available until recently nor are they yet available for unincorporated branches. However, excluding unincorporated branches and certain other types of corporations, payments to non-residents for business services in 1963 totalled $245 million, a slight increase over the 1962 figure. The manufacturing industries accounted for most of these payments, insurance and management fees and royalties being the main items for which payments were made.

7. Foreign investment, portfolio as well as direct, has been and is an important source of funds for the financing of capital formation in Canada. Although Canada was a net exporter of capital in the years immediately following the

war, in periods of rapid capital formation, such as from 1954 to 1957, Canada relied heavily on foreign financing. Canadian savings were adequate to finance 81 per cent of net capital formation between 1962 and 1965, but because some of these savings were invested abroad or used to retire debts held abroad, Canadians relied on direct foreign financing for 40 per cent of this capital formation. The use of foreign resources as a percentage of gross capital formation in the 1926-30 period was 25 per cent compared with 20 per cent in the 1962-65 period. The direct foreign financing of gross capital formation in the 1926-30 period was 50 per cent compared with 33 per cent in the 1962-65 period. (See APPENDIX)

8. Foreign ownership and control of corporations located in Canada is concentrated in manufacturing, petroleum and natural gas, and mining and smelting. Foreign ownership of Canadian manufacturing industries has increased substantially from 38 per cent in 1926 to 54 per cent in 1963, and foreign control has increased even more, from 35 per cent in 1926 to 60 per cent in 1963. Foreign ownership and control of mining and smelting have similarly expanded considerably, from 37 per cent in 1926 to 62 per cent in 1963 in the case of ownership and from

38 per cent to 59 per cent over the same period for control. For these two important industrial sectors, there has been a clear tendency toward increasing foreign ownership and control. In addition, a substantial petroleum and natural gas industry has developed and has absorbed large amounts of foreign capital; in 1963, this industry was 64 per cent foreign-owned and 74 per cent foreign controlled. Foreign ownership and control have declined, however, in both railways and other utilities from 1926 to 1963, for ownership from 55 per cent to 23 per cent, and from 32 per cent to 13 per cent, respectively, while foreign control of these sectors is now less than 5 per cent. Official statistics for the aggregate of these five industries and merchandising show that foreign ownership has declined slightly from 37 per cent in 1926 to 35 per cent in 1963 but that foreign control has risen sharply from 17 per cent to 34 per cent over this period.

9. Both ownership and control by United States residents have increased substantially since 1926 according to the official statistics. For the aggregate of the industries noted above, United States ownership has risen from 19 per cent to 28 per cent, while ownership by other non-residents has fallen from 18 per cent to 7 per cent. United

States control of the group of industries has increased from 15 per cent to 27 per cent, while control by other non-residents rose from 2 per cent to 7 per cent.

10. Within the manufacturing sector, there are certain industries where foreign control is very high, and in all such cases ownership is predominantly by United States residents. In 1963, foreigners controlled 97 per cent of the capital employed in the manufacture of automobiles and parts, 97 per cent in rubber, 78 per cent in chemicals and 77 per cent in electrical apparatus. The corresponding figures for United States control were 97 per cent, 90 per cent, 54 per cent and 66 per cent.

11. Not only is foreign equity capital concentrated in certain industries, but also it is concentrated in large corporations. In 1963, for 414 corporations with assets greater than $25 million, it is estimated that $19.9 billion or 53 per cent of the total $37.9 billion of assets in these firms were in firms more than 50 per cent owned by non-residents. On the other hand, for firms with assets of less than $25 million, $10.7 billion or only 32 per cent of the total $34.0 billion of assets in

these firms were in firms more than 50 per cent owned by non-residents.

12. Canadian private long-term investment abroad in 1964 totalled $5.3 billion of which direct investments abroad accounted for $3.4 billion and portfolio investments $1.9 billion. Canadian direct investments abroad have more than doubled since 1954, 60 per cent of which are now located in the United States. It is significant, however, that non-residents have an important equity in Canadian direct investments abroad arising from foreign ownership in whole or in part of Canadian companies having subsidiaries or branches in other parts of the world. Foreign equity and control of Canadian direct investment abroad accounted for 47 per cent and 43 per cent respectively of the total. United States equity and control alone accounted for 39 per cent in each instance.

13. At the same time as United States direct investment has been taking place in Canada, Canadian institutions and individuals, faced with a shortage of Canadian equities, have tended to be attracted to American equity securities. These investments are of a portfolio rather than direct investment nature, and do not result in

control. In the last few years, Canadian purchases of foreign equity securities have been substantial, averaging $27 million a year from 1961 to 1964, rising to $92 million in 1963 and $245 million in 1966, and standing at $66 million in the first six months of 1967. Over the same period, there has been a substantial net repatriation of Canadian stock owned abroad: $117 million average for 1961-64, $242 million in 1965, $83 million in 1966 and $53 million in the first six months of 1967. While this repatriation reduced foreign ownership, its nature does not appear to have been such as to reduce foreign control to a corresponding extent.

iv. Historical Perspective

1. The development of primary products, or staples, for export has been the cornerstone of Canada's economic development in the past. Resource discoveries and resource exploitation have attracted labour, capital and technology from abroad and facilitated the growth of population and national income. Access to external markets and the capacity to import labour, capital and techniques have been the underlying determinants of the expansion of the Canadian economy. Particularly in recent decades, the abundance of Canadian resources and their proximity to the United States have attracted American corporations to develop them, while the need for capital has led to a reliance on American capital with concomitant American ownership and control.

2. Manufacturing in Canada has grown up in the wake of resource development, directly to provide inputs for resource industries and to process raw materials, and indirectly to service the expanding domestic market consequent on population growth and rising incomes.

3. Industrial development has taken place historically within the framework of a national policy of improvements in transportation and communication, tariff protection, and the promotion of settlement and immigration. This strategy of economic development, by expanding the size of the domestic market, has helped to create Canada's present large manufacturing sector, though an undue willingness to tolerate inefficiency has facilitated the persistence of high costs throughout much of that sector. Both the expansionary and protective features of these national policies have operated to create an economic environment attractive to foreign capital and foreign ownership.

4. Much of the foreign capital imported before World War I was in the form of bonds sold to British bondholders. This British portfolio investment financed substantial parts of the heavy outlays on transportation deemed necessary to create a national economy and polity. Foreign sales of equity securities were also used to some extent in building Canada's infrastructure, as in the case of the British-owned Canadian Pacific Railway.

5. Direct investment, particularly by American corporations, became noticeable after the high tariff of 1879, but sharply increased in volume after World War I. Direct investment moved heavily into both primary industries, such as newsprint and base metals, and secondary industries, such as automobiles and electrical appliances. The rising importance of direct investment relative to portfolio investment in international capital movements, the growing dominance of the United States in the world economy generally and vis-à-vis Canada in particular, and the depletion of resources within the United States pulled Canada increasingly into the American orbit. The requirements of an expanding American economy combined with strategic considerations to increase sharply American demand for a range of Canadian resources, with market access and capital availability often facilitating American rather than Canadian ownership and control. The growth of the Canadian economy, partly consequent on external demand for resources, meant an expansion of the Canadian market, in terms of both population and standard of living, which promoted new opportunities for foreign as well as domestic entrepreneurs.

6. The outstanding fact of the history of the twentieth century is the pre-eminent position of the United States. American demand for imports of raw material and the spread of the American corporation, in manufacturing as well as in resource industries, beyond its national boundaries are manifestations of American success in creating and applying technology, in fostering consumer tastes, and in exploiting the advantages of the corporation as an institutional form. Technological leadership, brand names and entrepreneurial drive, with an assist from American tax policy, are the basic ingredients that have permitted the American corporation to extend itself nationally within the United States, and then internationally. The tendency of some American firms to regard Canada as not a foreign country hastened and strengthened penetration into Canada.

7. The nature of the Canadian environment also underlay the process by which foreign ownership and control has increased to its present proportions. The corollary of the superiority of the foreign firm has been the inferiority of the Canadian firm. The latter reflected certain deficiencies within Canada, some inherent

in the size of the economy, but others the result of the nature of Canadian policy.

8. The Canadian tariff, by segregating the Canadian market, encouraged foreign, and particularly American, firms to meet the threatened loss of sales by establishing branch plants and subsidiaries in Canada. Protected from the stiff winds of international competition, both domestic and foreign firms have performed less well than their counterparts in the United States. The Canadian tariff created job opportunities in Canada and thereby probably increased the size of the Canadian population and total national income, and the share of manufacturing in it. It would appear to have done so, however, at the cost of a less efficient industrial structure than would have existed had tariffs been lower. This means, in turn, that the Canadian standard of living, or real *per capita* income, is lower than it would otherwise be.

9. A reasonably well-developed capital market emerged only in the post-World War II period, but it has remained, in important respects, an extension of the New York market. Mobilizing risk capital,

as for large resource development has remained beyond the capacity of the private Canadian capital market. The prevalence of the wholly-owned subsidiary, which does not issue its shares to Canadians, has limited the supply of Canadian equities and inhibited the development of the Canadian capital market.

10. The quality of the domestic labour force has been improved, but not dramatically. Canadian education, particularly in this century, has lagged substantially behind the United States at all levels. Shortages of skills have tended to be obviated in considerable part through immigration, thereby lessening pressures to improve the Canadian educational system. The most serious deficiency has been the unsatisfactory training of top management with consequent deleterious effects on the quality of Canadian entrepreneurship.

11. War and government policy have provided a substantial impetus to research and development in Canada in this century, but Canadian achievements have been marginal. Canadian spending on research and development, especially industrial research, has been low relative to that of other developed

countries, while increasingly the competitiveness of a nation's industry has come to rest on its capacity to lead in technological innovation.

12. The Canadian economy, in both the private and public sectors, has been characterized historically by élite control and pervasive attachment to the status quo. There has been a hesitancy in perceiving and implementing changes in the Canadian environment, the recruitment and education of management being a case in point. While the ease with which foreign capital could be imported _via_ portfolio and direct investment, skilled manpower _via_ immigration, and technology and entrepreneurship _via_ direct investment has expanded the size and complexity of the economic base and increased opportunities for Canadians, it has, at the same time, diminished the pressures for Canada to develop these skills amongst Canadians to their fullest extent.

13. The economic benefits from foreign investment in Canada have been large and have contributed to the present standard of living. At the same time, the substantial contribution of foreign investment has not precluded widespread doubts about the efficiency of Canadian industry, and about the

capacity of the Canadian economy to experience self-generated growth.

14. Foreign investment, in its turn, has been one aspect of a process operative for a century, which has increasingly bound Canada to a North American economy. The tendency inherent in direct investment to shift decision-making power in the private sector outside Canada has, on occasion, posed serious problems for those responsible for formulating Canadian policy, and has created widespread unease among Canadians as to the continuing viability of Canada as an independent nation-state.

II. ANALYSIS

i. Multi-national Corporation and Nation-state

1. Foreign investment is sometimes discussed as if it was simply a movement of capital between two countries. The capital-importing country finds capital scarce at home. Benefits are derived from importing capital to the extent that productive investments are undertaken which would otherwise have been foregone or postponed. Foreign investment represents an addition to the country's capital stock, unless it tends to replace or discourage domestic investment.

2. If the borrowing takes place at a time when the economy of the capital-importing country is depressed, the investment being financed abroad could have been financed domestically through proper measures of the domestic monetary authorities. There will be no addition to the capital stock which could not have been achieved without foreign investment, and hence no benefit from the import of capital. The absence of benefit is attributable, however, not to the foreign investors, but to the domestic authorities.

3. Foreign investment provides not only capital but also foreign exchange. To the extent that the borrowing country has a shortage of foreign exchange, the initial contribution of foreign investment is greater than it would be if a shortage of capital were the only bottleneck.

4. The financial cost to the capital-importing country consists of the future stream of interest and dividends it must pay abroad. The servicing of the debt, and its repayment or repatriation, requires the capital importing country to forego consumption or investment and to adjust its balance of payments to effect the transfer of funds. To the extent that these adjustments are made with difficulty - because of a foreign exchange constraint - foreign investment imposes an additional burden on the capital-importing country, just as there was an additional benefit at the time the loan was received.

Portfolio investment

5. This way of looking at foreign investment is relevant to portfolio investment. The sale of bonds on the international capital market results in an inflow of capital and subsequent outflows for interest and redemption. The sale of stocks, where the buyer does not have voting control of the company whose shares are being purchased, similarly results in an inflow of capital and subsequent outflows of dividends; in this case, however, there is no automatic redemption over time.

6. Portfolio investment - investment in bonds and minority holdings of equity - does not result in legal control of the assets of the issuing corporation. Foreign portfolio investment is foreign investment without foreign control.

7. Most of the concern within Canada in recent years about foreign investment has not been about the inflow of capital itself, but rather about foreign ownership and foreign control of Canadian economic activity. Indeed, the view has frequently been expressed that Canada must continue to import capital, but should increase the extent to which

this takes the form of bonds so as to reduce foreign ownership and control. The primary concern has been with foreign direct investment, where the foreigner owns sufficient stock, or equity, in a Canadian corporation to have voting control.

Direct investment

8. Direct investment is very different from portfolio investment. Direct investment is a "package" of product, technology, management and market access, as well as capital. The components of the package are transferred not through the market place, but within the corporation from the parent to the subsidiary. The vehicle of direct investment is the multi-national corporation.

9. The existence of foreign direct investment indicates the advantage of the foreign corporation over the domestic corporation. Direct investment occurs most often because of some superior factor provided by the foreign corporation which is not in the possession of a similar domestic corporation. This advantage, or superiority, constitutes a necessary but not sufficient condition for direct investment. The existence of direct investment also is a manifestation of the preference of the foreign corporation to exploit its advantage within its own corporate structure, rather than offering it in the market to independent domestic corporations.

10. When it makes a direct investment abroad, the corporation becomes multi-national. In

varying degrees, it harmonizes, integrates, and co-ordinates the activities of its divisions in different countries. In most cases the head office must be consulted on major policy changes, particularly on financing, and it exercises an overall co-ordinating control.

11. Foreign direct investment is not an economic phenomenon alone. It is also a political phenomenon. Foreign control means the potential shift outside the country of the locus of some types of decision-making. The extent to which decision-making within the host country is eroded varies with circumstances, and basically depends on the power of the foreign firm and its government relative to the government of the host country. To the extent decision-making is eroded, national independence - being, in a broad sense, the ability to make decisions in the national interest - is reduced. But the effects on independence are not solely in the direction of reduction. Foreign ownership opens up new channels of communication, public and private, which are, in principle, two-way. Hence, foreign ownership may increase national independence in some respects - as when preferred access to foreign markets for resources results from foreign ownership and strengthens the national economy of the host

country - as it decreases it in other respects - as when the government of the parent firm makes the foreign subsidiary subject to its laws and policies.

12. The economics and politics of direct investment center on the interaction of the multi-national corporation and the nation-state - two of the most important institutions of the contemporary world. The benefits and costs of direct investment can be understood by considering the nature of these basic institutions and by analysing the areas of harmony and of tension between them.

Multi-national corporation

13. In advanced western economies, the dominant private institution is the corporation. The great preponderence of industrial and financial activity takes place within the corporate sector. A striking characteristic of the corporate sector is the dominance of a small number of large corporations.

14. The corporation mobilizes labour and capital on a large scale. Corporate savings account for a significant portion of the capital formation taking place. The corporation is the major entrepreneurial force of modern capitalism, creating new products and new techniques of production. It spends large sums on advertising and on research and development. It is a primary locus of decision-making, from routine day-to-day decisions through to long-range planning. In its most developed form, ownership and control are divorced, with the former widely diffused among many stockholders and the latter concentrated in the hands of management. A primary concern is profit-maximization. Within that context, the corporation attempts to control elements of uncertainty in its environment. It also attempts to grow - in part, to maintain its market share, in part, to "empire-build" for its own sake.

15. The prevalence of the corporation has important consequences for the operation of the market economy. By its nature, the corporation constitutes an alternative to the market to the extent that it can substitute transactions within the corporation for transactions on the open market. An example is the "purchase" of raw material by a parent firm from its subsidiary. Because of its size, both in absolute terms and relative to the markets within which it operates, the large corporation typically has market power. Specifically, it can have the power to influence the price at which it sells; it can be a "price-maker" and not merely a "price-taker".

16. Being a creature of the state, the corporation is subject to laws and national policies. On the one hand, it adapts to the structure of law and policy and typically prides itself on being "a good corporate citizen". On the other hand, when it is large, the corporation is one of the significant influences in shaping law and policy. Corporate managers are likely to feel a need to influence government simply in order to preserve the stability of their

corporations. The large corporation has a political impact, as well as economic power.

17. The corporation, and particularly the large corporation, plays an ever more dominant role not only within national markets, but in world markets. A significant proportion of the flow of commodities, particularly of raw materials, represents a movement from one division of a multinational corporation to another. The percentage of long-term private capital movements accounted for by foreign direct investment is high. The dynamic corporation attempts to grow by exploiting abroad the advantage, such as technological leadership, brand names or managerial skills, on which its success at home is based. Primary manufacturing firms may go abroad to guarantee supplies of raw material. Secondary manufacturing firms may view direct investment as an alternative to exports in the face of transport costs, the peculiarities of local markets, the need to supply on-the-spot servicing facilities, real or potential competitors, and foreign tariffs; the last is frequently the dominant consideration.

18. The extra-national extension of the corporation adds two dimensions to its nature. The first is the effect on the decision-making structure as a result of distance, cultural differences, and the policies of host countries. The process of geographic extension across national boundaries can be expected to require some decentralization. In fact, prior decentralization, either regionally or by product, may provide the experience necessary for foreign direct investment. The evolution of the American corporation, even within the United States itself, indicates that some decentralization of decision-making is necessary in the interests of the efficient functioning of the corporation. When the national corporation becomes the multi-national corporation, decentralization necessarily takes place.

19. The relation between ownership and control in the large corporation is different when the corporation is a subsidiary. Ownership is not widely diffused among many stockholders, but rather concentrated, often to the point of the parent being the sole stockholder. In effect, ownership rights are exercised by the management of the parent corporation. The management of a

subsidiary, wishing to exercise effective control over decisions, faces not a multitude of relatively powerless shareholders but the managers of its parent.

20. The second new dimension is the effect on the nationality of the corporation. There is a range of possibilities. The direct investment corporation may be essentially a national corporation operating extra-nationally, insisting on the primacy of the methods it uses at home, and even of the laws of the home country. Or it may be a multi-national corporation in a genuine sense, sensitive to local traditions, and respecting local jurisdictions and policies. Or it may be global, with such pervasive operations that it is beyond the effective reach of the national policies of any country and, in the absence of supranational policy, free to some extent to make decisions in the interest of corporate efficiency alone. These three possibilities - along a spectrum - imply different corporate behaviour, with differing consequences for the economy and polity of a host country. It cannot be doubted that how the corporation interprets its nationality is relevant to the host country.

Nation-state

21. The second dominant institution of the contemporary world is the nation-state. Its legal essence is its sovereignty. Its political essence is its independence. Neither are absolutes; the interdependence of nations has always been a reality and is becoming more so today. But a nation can continue to exist only to the extent that it withstands erosion of its sovereignty and resists loss of its independence from unnecessary sources.

22. Throughout its history, the nation-state has been concerned with economic growth. It is now generally committed to raising the standard of living of its citizens. Increasingly, it has taken responsibility for creating and maintaining a stable and high rate of economic growth. Historically, it has created the legal environment within which the corporation has flowered. Increasingly, it attempts to create a set of policies within which the corporation will operate efficiently for the public good.

23. In spite of increasingly global interdependence, the nation-state remains a vital reality in the

world today. While in certain respects national interest must now be blended with supranational authority, the tasks of the nation-state appear to have increased rather than diminished. Rapid technological change is the pre-eminent fact of life around the globe. Power accrues to nations capable of technological leadership, and technical change is an important source of economic growth. All nations must adapt to pervasive technological change. The nation-state, as the dominant institution of the world, has come to play an increasingly importantly role both in creating new technologies and in controlling their impact, as is evident from government subsidies to research and development, on the one hand, and programs to aid those who are disadvantaged by technical change, on the other.

Harmonies and tensions

24. It is the purpose of this introductory section to provide a broad framework for the subsequent discussion and to indicate some of the factors which should be taken into account. It is also useful to set out plausible hypotheses for consideration later in this Report. It must be borne in mind, however, that actual benefits and costs can only be established, if at all, from empirical evidence, and the latter is not being presented at this point.

25. From the perspective of the host country, the process of foreign direct investment creates two important sets of relationships: between the government of the host country in which the branch or subsidiary is resident and the multi-national corporation, and between that government and the government of the country in which the parent corporation is resident. In each case, a coincidence of interests permits of a harmonious relationship of mutual benefit, while a divergence of interests creates tensions and the possibility of conflict and cost.

26. In the important area of economic growth there is a substantial element of harmony in the

interaction of the multi-national corporation and the host country. The creation of economic growth is a major goal of the nation-state. It is likewise a major consequence of the global operations of the corporation. Direct investment, as a package of product, technology, management, capital and market access brings with it large potential economic benefits for the host country; certainly these benefits are larger than are imagined by those who conceive of foreign investment as being simply a capital flow. Undoubtedly, a host country which restricted foreign investment, and did nothing else, would risk creating economic stagnation and turning the country into a technological backwater. Furthermore, with economic benefit can come national political benefit. A rich and growing country is more capable of pursuing independent policies at home and abroad than one that is poor and stagnant.

27. One of the most important benefits that typically accrues to the host country from foreign direct investment results from the effects on its foreign trade. Direct investment in resource industries is typically export-creating, while direct investment in manufacturing

can be import-reducing, particularly when induced by a protective tariff, and sometimes export-creating. Hence, direct investment can increase employment in the host country, improve its balance of payments, and augment its standard of living. If these do not occur - for example, the balance of payments worsens in the long-run because of the drain from servicing the capital inflow, or the standard of living fails to rise because the new industry created is higher-cost, even in the long-run, than imports - they are more likely to result not from the inherent nature of foreign investment, but rather from its inefficient use by the host country. In sum, the host country typically benefits, and often substantially, from foreign direct investment.

28. Yet the very inflows of inputs that come with foreign investment and create the benefits also tend simultaneously to generate costs or problems. The influx of senior personnel from the parent provides management skills of a higher quality; but the ease with which managerial and entrepreneurial skills can be imported may reduce incentives to improve these skills in the host country. Capital inflow increases aggregate

saving and investment and the rate of economic growth; but the institutional development of a national capital market may be inhibited and the range of choice facing the investor reduced. The direct investment firm provides easy access for the subsidiary to the technology of the parent; but the latter is not necessarily the appropriate technology for the host country, and the potential to become a leader rather than a follower may be diminished. Foreign affiliation may provide an assured market for the subsidiary's output, particularly of raw materials and semi-processed goods; but, to the extent the taxation authorities do not ensure otherwise, the resulting "prices" may not result in maximum benefit for the host country. In manufacturing, the subsidiary gains access to the trademarks for tested products and the residents of the host country to the latest consumer goods; but the subsidiary may become simply an appendage of the parent, copying products for the domestic market and, in the unlikely event it is efficient, restrained from exporting, while the absence of distinctive national products may limit national advertising and impede the development of national media in the host country.

29. Foreign direct investment can be presumed to represent the advantage of the foreign firm relative to the domestic firm. While that advantage may be superior technical and managerial efficiency, it may also be based on market power of a monopolistic or oligopolistic nature. Whether the consumer gains - and it is this that is the touchstone of economic welfare - depends on whether foreign investment tends to lower prices rather than increase profits accruing to foreign shareholders. The existence of oligopoly in an industry implies, among other things, a redistribution of income from consumers to oligopolists. When the owners are Canadians, the redistribution takes place within Canada. When the owners are foreigners, this redistribution effect works against the economic benefit of Canadians.

30. Viewed in this way, it is clear that both economic benefits and economic costs can inhere in foreign investment. The major economic benefit is the contribution to economic growth. The major economic cost is the possible impediments to the creation of a more independent national economy. It is, however, highly probable, to say the least,

that the economic benefit exceeds the cost of having no direct investment. Greater quantities and higher qualities of inputs must generate some economic benefits for the host country. Furthermore, the economic costs depend critically on the policies of the host country, particularly on whether or not the will is maintained to improve the quality of domestic inputs and to maintain generally an environment in which firms, foreign and domestic, are both able to be efficient and are penalized for not being efficient. These latter considerations suggest that the benefits from foreign investment may be subject to diminishing returns, that is, while some foreign investment provides a spur to the domestic economy, beyond some point it may become a crutch.

31. It has been argued that all firms strive to maximize profits, and that the host country should be indifferent, even on narrow economic grounds, to whether a firm is a separate national enterprise or an affiliate of a multi-national enterprise. The latter is not necessarily correct policy. A parent firm may expect its subsidiary to behave in such a way as to maximize the global profits of the multi-national enterprise rather than the profits of the subsidiary itself. The interest

of the host country, however, is in maximizing the efficient growth of the subsidiary. In some cases, this makes little difference, but this need not always be the case. The parent may find it in its interest to limit the subsidiary in its freedom to export. It may be restricted to affiliates in its sales, or it may be required to observe market-sharing arrangements made by the parent. Likewise, the parent may impose restrictions on procurement; it may be required to buy from affiliates, or to import, rather than buy from local sources. But these possibilities can also work in reverse, and thus to the economic advantage of the host country. It should also be noted that a multi-national firm does not maximize global profits by restricting its efficient subsidiaries.

32. But multi-national firms are not simple profit maximizers. They have multiple concerns and live with multiple constraints, reflecting diverse interests within the corporate family and differing pressures from governments in various countries. Many of their decisions grapple with an uncertain and distant future, and it does excessive violence to their problems to imagine that there is a single best solution. Different firms have their own time and space horizons. Actual decisions will be affected,

to some extent, by the nationality of the head office and by the national environment within which a decision is taken. If there were many firms in an industry, the views of any one would not much matter, but where there are only a few firms, this is no longer so.

33. The range of productive inputs that come with direct investment ensure substantial harmony of interest between the host country and the multi-national corporation. At the same time, sources of tension inhere in the administrative structure of the multi-national firm. Corporations going abroad exhibit a marked preference for direct investment in a branch or subsidiary rather than licensing arrangements or joint ventures with local firms, and show a further, and very strong, preference for a wholly-owned subsidiary rather than a subsidiary with local minority shareholders. Such corporations are reluctant either to share the return that results from their special advantages, or to dilute ownership in such a way that it becomes more difficult to maintain control over the subsidiaries. In part,

the firms want "to capture all of the rents"; in part, they wish to avoid the inconveniences that result from letting outsiders have a voice in how the firm should be run. The widespread phenomenon of the wholly-owned subsidiary with the parent reluctant to sell shares in its subsidiary results from the corporation's pursuit of its own interest. The host country, however, may prefer joint ventures and licensing agreements in order to keep domestic firms in existence and to create potential growing points for domestic entrepreneurs, in spite of certain inefficiences in such arrangements. Or the host country, while accepting the direct investment firm, may want foreign subsidiaries to issue shares locally so as to define more sharply their status as political and economic entities resident in the host country, in spite of certain costs to the host country from such arrangements.

34. The fact that the subsidiary is not an entity fully distinct from its parent can create problems with respect to the meaning and availability of financial information about the operations of the subsidiary. Since the transactions between the parent and its subsidiary take place within the firm, rather than in the market, there may be

considerable scope for arbitrary valuation of intrafirm transactions. This poses special problems for the government of the host country, particularly its tax collectors and customs officials. Those problems are further complicated when the subsidiary is wholly-owned by the parent. The corporation may not regard the subsidiary as a separate entity for public accounting purposes, and hence will be reluctant to issue separate financial statements for the subsidiary. The issue cuts deep from the viewpoint of the host country, however, for many of even its largest corporations, which happen to be wholly-owned subsidiaries, may not disclose. Not only is the public denied important information, but government departments find themselves deciding important matters of policy without adequate statistics. Where this situation persists, however, the fault must be assigned to the government of the host country for failing to take a strong stand.

35. The multi-nationality of the subsidiary affects the exercise of national economic policy, sometimes increasing its scope and efficacy, other times reducing and constraining its effectiveness. The operation of monetary policy becomes more complicated to the extent

that foreign-owned firms have access to the financial resources of the parent. Tariffs tend to become more effective in creating employment in manufacturing when foreign firms are willing to set up subsidiaries, but less effective in building up local entrepreneurship. A policy of free trade remains an effective weapon to compel efficiency, but risks centralizing decision-making within the multi-national enterprise, and lessening the susceptibility of the subsidiary to the policies of the host country to the extent that head office management is less responsive to the latter than local management. The task facing anti-monopoly policy is made easier to the extent that a major force increasing the number of firms is the willingness of foreign firms to enter, but made more difficult to the extent that a major force limiting the number of firms in some industries are the barriers to entry created by foreign firms. The scope for corporate tax policy is increased to the extent that foreign investment enlarges the tax base, but reduced to the extent that multi-national firms are more able to shift operations across national boundaries in order to minimize taxes. The effectiveness of export promotion policies is increased if subsidiaries have access to the

world marketing facilities of the parent, but decreased if subsidiaries are constrained by the parent in their freedom to export.

36. Foreign investment tends to integrate the economies of the host country and the country of origin. When foreign ownership becomes pervasive, as in the case of American ownership in Canada, the industrial structures become intermeshed. The economy of the host country may take on a dependent character, supplying resources for the country of origin and inefficiently replicating the latter's manufactures. Tariffs for manufacturing in the host country are defended as necessary to maintain the vestiges of a national economy, but attacked as inefficient and eroded by pressures for rationalization and integration. The closeness of the economic ties fostered by foreign investment, as between Canada and the United States, create opportunities for Canada, but may also engender feelings of dependence of the former on the latter and risk creating a concessionary attitude by policy-makers in the host country going beyond economic matters alone.

37. Some of the most important of the harmonies and tensions, or benefits and costs, that result from foreign ownership and control are the explicitly political. Flows across national borders of factors of production and of goods and services tend to bind national economies, and even national polities, more closely together. Insofar as there is a broad coincidence of interest between nation-states, their closer integration need not be costly from either national perspective and may, indeed, be seen as mutually beneficial. Certainly the home country typically sees its multi-national corporations as creators of political benefits. At the same time, some tension is very probably inevitable, given the high probability that the host country will be smaller and less affluent than the country of origin.

38. The most serious and intractable of tensions results to the extent that the home country, in which the parent is resident, regards the entire multi-national enterprise as subject to its jurisdiction and policies. Since the parent and its subsidiary are resident in different countries, they are necessarily subject to

different laws. The home country, however, may believe that the maintenance of its national independence and sovereignty and its capacity to carry out national policy require it to regard the subsidiaries of its parent corporations as falling within its jurisdiction. At the same time, the host country is likely to believe that the maintenance of its national independence and sovereignty and its capacity to carry out national policy require it to regard resident foreign subsidiaries as falling within its jurisdiction. From the viewpoint of the host country, the extraterritorial extension of law is an undeniable cost of foreign direct investment. Overlapping legal jurisdiction threatens the national sovereignty of the host country. The unilateral extension of the laws of one country into another is a serious matter, without respect to the content of the law or the motives of the former country. If the content of the law conflicts with the policy of the host country, the situation simply becomes more tense. The corporation itself is confronted with two peaks of sovereignty; it must choose and might be expected to defer to the higher peak. In the nature of the case, the higher peak will typically be the home country.

39. While the problem of extraterritoriality can arise, in principle, in a variety of ways, its actual manifestations in recent years have been with respect to United States laws on freedom to export, United States anti-trust law and policy, and United States balance of payments policy. In the pursuit of its foreign policy objectives, the United States has placed restrictions on the freedom to trade of subsidiaries of its parent corporations; a host country which regards the freedom to trade of its corporations as consistent with its foreign policy objectives, finds its foreign policy, which is the external manifestation of its political independence, being undermined. In the pursuit of its objective to maintain competition, the United States has extended its anti-trust policy to firms resident abroad which are subsidiaries of American parents; a host country may have different views on how to maintain competition, or even on whether this is a primary issue. United States balance of payments guidelines direct parent firms, among other things, to control their subsidiaries in ways which will tend to improve the balance of payments of the United States; this diminishes the independence of the host country by threatening to weaken

its balance of payments and the efficient growth of its American-owned subsidiaires.

40. Large firms with market power dominate direct investment in the western world, and this has political as well as economic implications. With size and economic power, firms are no longer simply disciplined by the impersonal forces of the market, but rather have some autonomy in decision-making. To the extent that foreign ownership is embodied in firms with this kind of power, there is a diminution of decision-making within the host country that would not result if the firms were small and fully subject to the discipline of the market.

41. A final area of tension arises from the issue of foreign ownership of those sectors of the economy which the host country regards as "key sectors", or "vital sectors". It is a universal characteristic of countries to exclude or limit foreign participation in some sectors. While there is great variety, the most frequent candidates for special

treatment are communications, transportation and finance. The criteria for designation also vary, but considerations most frequently cited are national security, cultural survival and national control of the "commanding heights" of the economy. Tensions tend to result when the rules defining key sectors are not sufficiently clear, or when public reaction comes after foreign entry has taken place. For each country, its key sectors tend to be rooted in its history and its politics and to be associated with a public sensitivity that may seem irrational to foreigners, but is none the less real.

42. The examination of the tensions as well as the harmonies, and the costs as well as the benefits, that are associated with foreign investment is necessary if policies are to be devised which will permit both the multi-national corporation and the nation-state to thrive. At the same time, the important issue today for host countries such as Canada is not whether foreign investment is worthwhile, but rather how to increase benefits and decrease costs.

Policy

43. Certain broad policy choices can be outlined in this introductory discussion. It has been emphasized that the corporation is a creature of law and is subject to national law and national policy. The major policy concern of a government surrounded by corporations should be to create an environment within which the corporation functions for the public good. This is true when the corporations are national; it remains true when they are multi-national.

44. Since the operations of the multi-national firm transcend the jurisdiction of any single nation, a case can be made that it should be subject to international, or supranational, control and, indeed, will not otherwise be effectively controlled in all respects. In the absence of these international or supranational controls, it follows that host countries should cooperate in their creation.

45. Until effective international or supranational policies do evolve, however, and their creation is not imminent, separate national policies are clearly superior to no policies. Multi-national corporations have substantial economic power and political influence,

and their operations are far too important to many people for nation-states to ignore them.

ii. Sources of Economic Growth

1. Foreign investment contributes to economic growth by bringing capital, entrepreneurship, technology and access to markets. These are the positive contributions to growth. The relevant questions are: how much? at what cost? are there efficient alternatives?

2. To evaluate the particular contribution of foreign investment to economic growth, it is necessary to look at the sources of economic growth in general. The total amount which a country can produce at full employment is limited by its supply of land, labour and capital on the one hand, and by the state of techniques used to combine these factors of production on the other. The rate of growth of domestic production is then determined by the rate of growth of the supplies of these factors of production and by technical progress.

3. Economists have conventionally considered the rate of growth of real capital stock, and therefore investment, as the key to economic growth. Recent empirical research, however, has downgraded the importance of investment and stressed the role of technical progress.

It now appears that a major source of measured economic growth in many countries is the increased productivity of the factors of production arising from improvements in their quality and in the efficiency of their use. Improvements in the quality of resources include more education and skill of the labour force, improved capital equipment and improved attitudes and enterprise of the work force. Improvements in the efficiency of use of resources stem from more efficient organization of the production process, economies of scale, and shifting resources from low-productivity to high-productivity activities.

4. These findings, which downgrade the relative contribution of investment in the growth process, by implication reduce the importance of foreign investment in explaining economic growth. This generalization is subject, however, to two qualifications. First, foreign direct investment, being more than a capital inflow, may bring with it some improvement in productivity for some or all of the reasons just cited. Second, the importance of investment tends to be restored to the extent that gross investment is necessary for the implementation of new technical knowledge. When this is so, foreign investment allows a more

rapid rate of technical advance and its benefit is enhanced. Not all knowledge, however, requires investment for its implementation. Unfortunately, only rough measurements exist to date of the extent to which the application of new technology is intimately related to investment.

A Measurement of Net Economic Benefit

5. The contribution of foreign investment can be quantified by determining, first, the extent to which foreign investment permitted of an increase in the capital stock that would not otherwise have taken place; second, the amount of technical change that took place only because it was embodied in the increment to the capital stock resulting from foreign investment; and, third, the return on capital paid abroad which must be deducted to calculate the net benefit. The extent to which foreign capital, in fact, increased the capital stock depends on the foreign capital being used to increase the level of investment rather than the level of consumption, and on whether the foreign-financed investment simply replaced domestic investment because of reliance on a fixed exchange rate system. Moreover, given unemployed resources, the increase in the capital stock could have been achieved by the use of different domestic policies. Judgments can be made and, depending on circumstances, measurement of the net benefit is possible. The extent to which technical change is embodied, or disembodied, in the capital

stock resulting from foreign investment cannot be determined with accuracy, but calculations can be made on the assumption that all technical change is embodied, on the one hand, and on the assumption that all technical change is disembodied, on the other. The return to capital can be determined from the payment of interest, dividends, and business services of various kinds to non-residents.

6. Estimates of the net benefit have been attempted for the period since 1950. For the years 1950 to 1956, Canada experienced full employment, except in 1954, and was on a flexible exchange rate system. Being at full employment, Canada was in an excellent position to enjoy the full potential benefit of foreign investment. It is fairly certain that the resources provided by foreigners, or their equivalent, were invested rather than consumed, and that the capital inflow was large enough to have had a significant impact on Canadian capital formation. On the assumption that the rate of technical change is independent of the rate of investment, net foreign investment in this period raised per capita real income in Canada by 1.4 per cent. Since per capita real

income grew by about 17 per cent in this period, the portion attributed to foreign investment is about 8 per cent. On the assumption that the contribution of technical improvements to economic growth is implemented through additions to capital stock, net foreign investment increased per capita real income by 3.25 per cent. This, in turn, constitutes about 20 per cent of the total growth of per capita income that actually took place in this period. If it is assumed that a significant part of technical progress is implemented by additions to capital stock, as seems reasonable, then foreign investment had a significant impact on Canadian economic growth in this period. Since this estimate is based on <u>net</u> capital inflow, after deducting Canadian investment abroad, the contribution of gross capital inflows would be larger. The estimate also includes both portfolio and direct investment; the contribution of the latter alone would be smaller.

7. Canada left the full employment path in 1957 and thereafter the measurement of the benefit becomes more difficult. Unemployment results from an excess of planned domestic saving in relation to investment plans, given an inappropriately

tight monetary-fiscal policy. On the one hand, foreign investment adds to resources and thus to deflationary pressures. On the other hand, foreign investment creates investment opportunities to the extent that foreigners have knowledge or risk-taking capacity not possessed by Canadians. If the extra supply of resources financed by the capital inflow exceeds investment opportunities created by it, the effect is deflationary in the given circumstances of domestic oversupply and inappropriate domestic policy. It is difficult to determine, in fact, whether the contractionary or expansionary effect of foreign investment is greater in such a set of circumstances.

8. In the period of substantial unemployment and a relatively stagnant economy from 1957 to 1961, it is nevertheless likely that foreign direct investment was beneficial in the sense that it had an expansionary effect and financed capital formation which would not have occurred otherwise. Canada might have been better off, however, without foreign portfolio investment and the long-run debt burden incurred thereby. Such investment probably had a depressing effect by increasing the (flexible) exchange rate, thus

discouraging exports and encouraging imports and so depressing Canadian production. Moreover, it financed investment which would have been financed by Canadians in its absence, given that there were unemployed resources and that such investment carries no peculiarly greater technical or risk-taking capacity. The true culprit, however, was not portfolio investment, but rather overly tight monetary-fiscal policy which led to more borrowing abroad (and exchange rate appreciation) than was necessary or desirable. The potential benefit from portfolio investment was wasted as a result of misguided policies. Alternatively, given the extent of unemployment, foreign portfolio investment could have been curtailed - though this in itself would not have cured the unemployment. In any event, the circumstances preclude a numerical estimate of the net benefit.

9. In 1962 Canada entered a period of rapid economic expansion and, coincidentally, a fixed exchange rate was reinstated. Unemployment rates remained high until 1965, though it is likely that if Canada had attempted to expand more rapidly in the period 1962-65 inflationary pressures would have been intensified. Assuming that Canadians would not have accepted more inflation in order

to eliminate the unemployment, foreign investment financed economic growth that would not otherwise have taken place. Under these circumstances, the potential benefits of foreign investment are comparable to those resulting when the economy is at full employment as in the period 1950-56.

10. A relevant difference between these two periods, however, is the change in exchange rate policy. Whenever a continuing capital inflow takes place, the monetary transfer must be accompanied by a real transfer of goods and services that manifests itself as a deficit in the current account of the balance of payments. Under a flexible exchange rate system, the exchange rate appreciates, thus discouraging exports and encouraging imports. Under a fixed exchange rate system, the same effect on exports and imports would have to be achieved by rising domestic prices, or inflation. If such inflation is deemed undesirable, it can be curbed by tighter monetary policy. But this discourages domestic investment, with the consequence that a portion of foreign-financed investment simply replaces domestic investment; at the same time, the Canadian government acquires additional foreign exchange

reserves. Adherence to a fixed exchange rate in periods of neavy capital inflow can significantly reduce the net economic benefit of foreign investment. In fact, no numerical estimate has been made of the contribution of net foreign investment to Canadian economic growth since 1961.

Diffusion of Net Benefits

11. An alternative way of attempting to evaluate the contribution of foreign investment to economic growth is to examine the process whereby benefits are gained. Assume that a new plant is established in Canada by a foreign company. A direct effect is to increase the amount of capital which labour has to work with, and thus the wage rate. The consumer may benefit directly via lower prices or better quality, provided competition exists in the industry. On the other hand, the effect on profits depends on the firm being considered. Those which are competitive with the new firm will find their profits reduced, or less than they would otherwise be, because of higher wage rates and/or lower selling prices, and possibly a reduced share of the market. The profits which are reduced may be those of foreign-owned firms, depending on the previous ownership of the industry. There is a further, and substantial, benefit through the taxes levied by the host country on the profits of the firm. Taxes on profits of foreign-owned firms help reduce the burden on Canadian residents, except to the extent that the taxes so raised are used to subsidize foreign capital. If the foreign investment occurs by

a take-over of an existing firm, rather than a new investment, the analysis at this level is essentially the same if the Canadian recipients of the take-over funds use the proceeds for investment. This is evident if the funds go to real investment. If they are invested in Canadian securities, they tend to lower yields and create real investment elsewhere in the economy.

12. In this example, it has been implicitly assumed that the technology of the new foreign firm was no better or worse than that of the existing Canadian firms. Foreign direct investment, unlike portfolio investment, may bring with it technical and managerial skills when the new plant is established or taken over, and also on a continuing basis in terms of access to the knowledge of the parent and other affiliates abroad. Typically the research and development, patents and trademarks, production and distribution techniques, and technical and managerial skills of the parent are available to the subsidiary.

13. If a better technology than the existing Canadian technology is introduced as a result of foreign investment, several important consequences may follow. The key point is

whether the improvements get outside the firm and thus raise Canadian income generally, or remain in the firm and simply raise profits accruing to the parent. In particular, the benefits to Canadian productivity are enhanced to the extent that the new technology is imitated in the industry and is capable of being transmitted to other sectors of the economy. This could occur because of purchasing from other industries and any resulting improvements thereby in breaking supply bottlenecks, the introduction to the economy of new labour or managerial skills, or improvements in the production or distribution of goods and services. As before, the size of the benefits and who secures them also depends on the way in which these changes affect income, taxes, and prices. A reverse effect is also possible: if the technology introduced into Canada is simply that of the parent, without regard to differing ratios of factors of production in Canada and the differing nature of the market, the technology could be inferior to that used locally.

14. While foreign techniques are available through direct investment, there are alternative

ways of securing them. Patents can be licensed, foreign experts can be hired, nationals can be sent abroad for education, and foreign products can be copied. The relevant questions are the costs and degree of availability of techniques by different routes. In the case of direct investment, many firms pay little or nothing directly for access to the parent's knowledge; instead their profits are enhanced beyond what they would otherwise be, and the parent benefits in this way. Technology sold to independent firms requires a fixed payment, or perhaps a fixed percentage of sales or some similar method. The contrast is analogous to that between equity and bond financing, that is, between a return which varies with earnings and a fixed return. As to degree of availability, it appears likely that there is a fuller exchange of knowledge between related firms than between unrelated ones, since in the former case the parent can capture through profits what it does not charge for directly. Thus, while technology is available by other routes, it may be available at higher initial cost, more slowly, or less fully than via direct investment. The important difference, however, is that residents maintain

control of the assets and get the benefits of learning by doing.

15. Two key points emerge from this discussion. The first is that the nature and extent of the benefits from direct investment depend on the nature of competition in the system and the effects of public policies on the organization of production and distribution. Increased benefits for the Canadian public will result to the extent that competition within the Canadian economy diffuses the impact of direct investment widely, increasing productivity and decreasing prices. To the extent that imperfections of competition exist, and are not mitigated, or are even increased, by public policy, the benefits of direct investment will be emasculated. Consider the possible effects of foreign entry into a Canadian industry. The addition of another firm creates the potential for an infusion of competition to the benefit of the public. Inefficient patterns of production and distribution may be shaken up and this can constitute an important benefit. Conversely, these benefits will tend to be lost to the extent that the new firm adapts to the existing pattern of the industry, or further fragments an already small market in which all firms are sub-optimal

in size and high-cost, or creates higher barriers to further entry to the industry than previously existed. The extent of the benefits depends, then, at least in part, on the effectiveness of public policy in maintaining competitive behaviour, as through anti-combines legislation.

16. Assume further that the industry in question is protected by a tariff with the Canadian price at the foreign price plus the Canadian tariff and with some imports coming in; this is typically the case, in fact, in Canadian secondary manufacturing. Even if the foreign firm is more efficient than its domestic predecessors, in the sense that operating costs per unit of output are lower, all that may happen is that the production of the foreign firm replaces imports. Since the domestic price does not fall, the Canadian consumer is no better off. The change in welfare that entry has created is a loss of government revenues equal to the increase in domestic production times the per unit duty that could be collected minus taxes paid by the new firm. The advantages of superior access to technological advance, new managerial techniques, and capital are dissipated in the process of import replacement.

17. If the Canadian consumer is to benefit from foreign ownership it is necessary, given the tariff, that direct investment helps the Canadian industries into which it flows approach world levels of productivity. If it does not assist these industries in approaching world levels of productivity, its effect will tend to be neutral for the Canadian consumer, or even negative; the latter possibility can result if the foreign firm, while efficient relative to Canadian firms, is inefficient by world standards, and diverts Canadian inputs into relatively inefficient areas of production. The culprit, however, is not foreign investment but the Canadian tariff. In the absence of the tariff, production in Canada would have to be efficient by world standards; otherwise, Canadian demand would be satisfied by imports. Canadian industry would be competitive for it would have to face the stiff winds of foreign competition via imports. Again, then, the extent of the benefits depends, at least in part, on the nature of public policy in maintaining competition - in this case Canadian commercial policy.

18. The second key point to emerge from the discussion is that the nature and extent of the benefits from direct investment depend on the ability of Canadian governments to tax profits accruing to foreigners at an optimal rate. When the production of foreign firms displaces imports which would have yielded tariff revenues, it is important that the loss of tariff revenue be offset by taxes paid by the firm so that the tax burden on Canadians is not raised. If favourable effects on productivity and prices do not result from foreign investment, any benefit that does result will accrue largely as profits to the foreign firm and will only accrue to Canadians to the extent they share in those profits, as through the corporation income tax.

19. The importance of not dissipating the benefits through insufficient taxation is even clearer when the foreign investment is in a Canadian resource industry. Consider the case of a foreign firm which enters Canada to develop a new resource. Assume that the technique of production makes intensive use of machinery, which is imported, and uses little labour, and that the output is exported and at prices

determined, in part, by the foreign firm; these assumptions are often, though not always, realistic. To the extent that relatively little domestic labour is employed and the resource is exported, benefits will accrue mostly to foreign consumers and foreign factors of production, and Canadian benefits will consist largely of taxes imposed on foreigners. To the extent that the foreign firm is able, at least for tax purposes, to set the export price, Canadian benefit will further depend on the Canadian tax authorities ensuring that the firm, for whatever reason, does not price low and thereby shift profits and tax liability outside Canada.

20. The emphasis conventionally, and properly, placed on the importance of taxes collected on foreign profits in accounting for the benefit from foreign direct investment arises from the straightforward fact that the profits earned by foreign firms accrue to foreigners, that is, taxation is a device by which residents of the host country share in profits. An alternative means of resident participation in profits is resident ownership of shares of the subsidiary. Such participation would not necessarily create a <u>net</u> benefit, however, since (future) participation

requires the using up of (present) Canadian capital. The cost involved - in the context of a discussion of the sources of economic growth - depends on whether this is an efficient allocation of (scarce) capital, that is, whether the opportunities foregone would have created relatively more or relatively less future benefit for Canadians generally.

21. The foreign firm, as well as bringing capital and technology, also brings its product in the case of manufacturing. One of the advantages which the foreign firm has over its domestic counterpart is the trademarks and brand names of its parent. Some part of what is often seen as the technical superiority of the foreign firm is properly attributable to this marketing advantage; indeed, technical progress proper and product innovation to create a differentiated product for marketing advantage are frequently inextricably intertwined. Whereas technical progress unambiguously increases consumer welfare, the welfare effects of product differentiation are ambiguous. While the consumer has more choice, this is more apparent than real if the differences between products are contrived and slight; also the choice - which is the essence of the benefit - has been obtained at the cost of

using scarce inputs for advertising, and at the risk that future potential competition will face higher barriers to entry because of consumer brand attachment. At the national level, consumer attachment to foreign brands may inhibit the growth of domestic firms with domestic brands; the absence of national brands and distinctive national products may adversely effect national media and export prospects. In sum, while foreign investment based on product differentiation creates benefits, it also creates costs.

22. Other potential benefits associated with foreign investment accrue as a result of improved access to entrepreneurship and to markets. These benefits can be discussed conveniently in terms of capacity to undertake risks, for entrepreneurship can be defined simply to be that capacity, while market access is a particular example of risk-reduction.

23. Multi-national firms may have a greater capacity to undertake certain kinds of risks compared with domestic firms. Because of their higher degree of integration, or because of substantial capital or better access to credit, they may be in a better position to undertake

some risky investments. Again, foreign investors may possess different bodies of knowledge and techniques than Canadian investors when they examine Canadian investment opportunities. The result is that they may undertake projects, at given rates of interest, which would not appeal to Canadian investors, or would not appeal to them as soon. This greater capacity of the multi-national firm to take risk can redound to Canada's benefit. In the primary resource field, a guaranteed long-term market in the parent for at least part of the subsidiary's output has often been the critical factor in the decision to exploit the resource, sometimes much more important than the supply of capital or of technology. Similarly, it was not until foreign firms had risked the initial heavy capital commitments involved in a new technique of production, and had tested the markets, that resident-owned firms ventured into some areas of resource development and manufacturing. Sometimes it is not a case of initial risk but of waiting for eventual returns; in some Canadian industries the resident-owned firms were prominent in the early phase but sold out to non-residents.

24. While this greater capacity to bear risk generally works to Canada's advantage, this need not always be the case. Multi-national firms may also take a longer-run attitude to exploiting the primary resource after proving it up to the extent that they have alternatives elsewhere. Or, in secondary manufacturing, if an error has been made in terms of over-investment in a relatively inefficient sector, it may take longer to correct it if the staying power of the parent firm is particularly strong. More generally, the greater risk-bearing capacity of the foreign firm may be simply the other side of its monopoly power, and the latter is never an unalloyed blessing in terms of either consumer welfare or national policy.

25. While size and diversity in themselves may explain a different capacity to undertake a given risk, it may also be that attitudes to risk-taking vary in a deeper sense. Indeed, these attitudes may be the essence of entrepreneurship. The foreign firm may be, in this basic sense, more entrepreneurial, and the greater willingness to do new things in new ways can create substantial benefits for the host country. The determinants of this propensity to innovate, or its absence, are difficult to specify but probable factors

include the extent and nature of formal education of managers; social mobility, with the full range of sources of entrepreneurial talent not being exploited if entrepreneurs are drawn from a too limited or homogeneous part of the population; market horizons, which may be limited by tariffs or by private restrictions, and which cause managers to "think small"; and foreign control, which may leave local managers without the authority to make big decisions and hence impede the learning process. In most cases, public policy could improve domestic entrepreneurship and, by supplementing or even supplanting foreign entrepreneurship, reap important benefits.

26. While it is easier to list benefits than to measure them in a satisfactory way, some empirical observations can be made. The analysis indicates that direct investment can have favourable effects on Canadian productivity and Canadian prices. With respect to productivity, a statistical test has been designed to test the hypothesis that a relationship exists between the degree of foreign ownership in Canadian industry and that industry's performance relative to its counterpart in the United States. To the extent that direct investment

confers benefits via superior productivity, it might be expected that industries dominated by foreign ownership would perform better relative to their United States counterparts than industries dominated by Canadian ownership. One measure of performance is average labour productivity, as measured by value-added per worker. The test shows no statistically significant relationship between the degree of foreign ownership and the gap between Canadian and American average labour productivity. The test also rejects a relationship between 1963 levels of ownership and the change in Canadian labour productivity with respect to the United States over the five year period 1958 to 1963. Both of these results hold up if labour productivity is alternatively measured as value-added per production worker. Another measure of performance is size, on the assumption that there are economies of scale making large firms more efficient than small firms. The test does indicate that Canadian industries dominated by foreign ownership are somewhat closer to American size levels in terms of employees per establishment than are their Canadian-controlled counterparts. Nevertheless, even in these industries, Canadian size levels remain substantially below

American size levels. When value-added per establishment is used as a measure of size, there is no statistically significant relationship between ownership and size. Finally, an examination of data on individual industries shows that industries dominated by American firms appear both at the nadir of Canadian productivity as measured vis-a-vis the United States - toilet preparations, soap and cleaning compounds, and pharmaceuticals and medicines - and at peak levels where Canadian productivity is equal to or higher than that of the United States - smelting and refining, and petroleum.

27. These overall results, though inevitably subject to theoretical and statistical limitations, suggest that nationality of ownership is irrelevant to economic performance, or that foreign ownership does not produce above-average benefits that can be perceived from data on productivity and size. Foreign ownership is to be found across the broad spectrum of Canadian production, from highly efficient to highly inefficient industries as measured by labour productivity relative to the United States. While direct investment is usually regarded as a response of efficient firms to production possibilities abroad, at least in the Canadian

case it would appear that direct investment has also been a response to favourable market opportunities generated by high tariff rates and media and advertising spillover. As a result, foreign ownership has occurred randomly over the Canadian production possibility surface, in both valley and peak, and the movement of foreign firms into Canada has not moved individual Canadian industries towards American, or world best-practice, levels of efficiency.

28. An attempt has also been made to ascertain the benefits from foreign ownership from price data. The hypothesis tested is that a relationship exists between the degree of foreign ownership and the behaviour over time of Canadian prices relative to American prices. To the extent that direct investment confers benefits via price changes, it might be expected that prices in industries where there is more entry of foreign firms relative to domestic firms would rise less (or fall more) relative to the same prices in the United States than industries where there is less entry of foreign firms relative to domestic firms. Tentative and partial data, from which no firm conclusion can be drawn, indicate that the entry of foreign firms has not had a greater impact on Canadian price trends relative to price trends in the United States than the entry of

domestic firms. If this preliminary finding on price trends stands up to rigorous testing, it will be consistent with the much more reliable finding with respect to productivity, and would presumably be explainable along similar lines, namely, that new foreign firms enter not only to exploit production opportunities but also market opportunities created by the Canadian tariff and communications spillover, and that the latter motives do not necessarily create efficient production in Canada.

29. Further empirical evidence on performance exists at the level of the firm itself, partly from official statistics but mostly from private interviews and questionnaires. The nature of the data and its apparent meaning is discussed at length below (see Performance of Firms). Broadly, the major finding is that there are few significant differences in the economic performance of foreign-controlled and resident-controlled firms, with both being typically inferior to their American counterparts, and the major inference from the finding is that the nature of the Canadian environment within which firms operate is a more important determinant of their behaviour than is their nationality of ownership. This finding and the inference therefrom can be

seen as indicating that the performance of foreign firms is not generally superior to that of domestic firms and that the benefits from performance that might be hoped would come from foreign direct investment are not generally evident, in part at least because of deficiencies in the Canadian environment which might be corrected by appropriate Canadian policy. In general, then, independently collected statistical data on industry productivity and on performance of firms appear to yield essentially the same results and to be explainable along essentially similar lines.

30. It has been emphasized at a number of points above that the benefits from foreign investment will be enhanced to the extent that the Canadian economy is competitive. The structure of Canadian industry and the relationship between foreign ownership and the structure of industry is subjected to statistical analysis below, and the effect of Canadian anti-combines and tariff policy on competitiveness is considered (see <u>Structure of Industry</u>). There is ample evidence of concentration of market power in most Canadian industries, and it can reasonably be inferred that Canadian firms, without respect to ownership, are able to collude to maintain high prices in spite of the anti-combines legislation

and because of the Canadian tariff. Statistical evidence on the relationship between foreign ownership and industrial concentration and between foreign ownership and mergers indicates that foreign ownership has contributed at least its "fair share" to both. A reasonable inference is that, while foreign ownership may not have decreased the competitiveness of the Canadian economy, neither has it clearly increased it.

31. A possible explanation for the apparent failure of foreign ownership to increase competitiveness would be two-fold. First, in a number of Canadian industries, the dominant firms are subsidiaries of American parents which are the dominant firms in the United States; hence, the pattern of industrial concentration, or the dominance of a small number of large firms, which is prevalent in the United States is also prevalent in Canada. Second, the nature of Canadian policy has not only not precluded the absence of competitiveness, but has facilitated its absence. Canadian anti-combines policy appears generally to have been ineffective in creating price competition among firms, foreign and domestic, within Canada, while the Canadian tariff has both attracted foreign firms into inefficient production in Canada and protected them over long periods against price competition from imports.

32. It has also been stressed that the nature and extent of the benefits for Canadians from direct investment depend on Canadian governments taxing returns accruing to foreigners to the extent possible. The major potential source of tax revenue in this regard is the corporation income tax on the profits of foreign-owned firms. Data on 743 of the largest Canadian corporations - for which the criteria for selection is discussed below (see Performance of Firms) - shows that over 60 per cent of their profits accrue to the benefit of non-residents. Canadian tax authorities have, in fact, made effective use of the revenue-yielding capacity of the corporation tax with respect to all Canadian firms, and its application to foreign-owned firms has brought substantial benefits to Canadians.

33. The maintenance of the benefit depends substantially on the capacity of the Canadian tax authorities to ascertain that there is not, for some reason, overpricing on purchases from foreign affiliates and underpricing on sales to foreign affiliates by Canadian subsidiaries. The importance of close and comprehensive checking by the Canadian tax authorities has been increased in the past few years by the issuing of American corporate guidelines regulations which encourage American parents to

charge subsidiaries closer to arms-length prices for services rendered than they appear to have charged in the past in order to increase tax receipts by the United States. Moreover, while the effective rate of corporation taxation in Canada some years ago was below that in the United States, thus encouraging American-owned firms to so price exports and imports of goods and services as to throw more profits to Canada, the effective rate in recent years appears to be about the same as that in the United States. More generally, the maintenance of the benefit from taxes on foreign factors of production depends on the ability of the Canadian tax authorities to exercise caution in the granting of special tax treatment or special subsidies to industries which are predominantly foreign-owned, particularly industries which do not generate substantial earnings for Canadian factors of production. The Canadian tendency with respect to the taxation of some of the resource industries has been to emulate American generosity; because some of the industries are substantially foreign-owned it is probable that the Canadian benefit attainable through taxation has not been maximized.

34. A potential source of more tax revenue from foreign direct investment is the withholding tax on dividends and other income, such as payments

for management services, paid by Canadian subsidiaries to their foreign owners. The logic of this tax is that foreign factors, unlike domestic factors, do not otherwise pay personal taxes to the government of the host country, and its level, or at least its upper limit, is largely determined by the extent to which such a tax can be imposed without creating disincentives to foreign investors which would lower the yield from the tax. While the question of whether this tax is at an optimal level is an exceedingly complex one to answer satisfactorily, the fact that its change requires not only making allowance for the tax policy of other host countries, but also the renegotiation of tax treaties with investing countries, suggests that the potential for its increase is seriously constrained.

35. An alternative means of Canadian participation in the profits of direct investment firms is minority Canadian ownership. The extent of such participation by Canadians is at present relatively limited, reflecting the strong preference of foreign corporations for operating abroad through wholly-owned subsidiaries. For 375 of the largest non-financial Canadian corporate complexes in Canada (for a detailed discussion of these and other data on this topic, see below <u>Performance of Firms</u>), 162 or 43 per cent are private companies with no publicly traded

shares, and about 75 per cent of these private companies are controlled by non-residents. It has been estimated that approximately 18 per cent of the total corporate taxable income in Canada in 1965 was earned by about 130 of the largest private corporations, most of which were foreign-owned. The relevant question is whether the cost of gaining more participation is commensurate with the benefits, and the most important cost, at least so far as creating economic growth is concerned, is the foregone opportunities for use elsewhere in the economy of the funds required to get minority participation.

36. The sums involved for extensive minority participation are substantial, simply because of the prevalence of the wholly-owned subsidiary. While the complexities of estimation are such that no estimate can be other than an informed guess, the sum required, for example, for 25 per cent minority ownership of the larger foreign subsidiaries (having assets of $25 million or more) appears to be in the order of $3.5 to $4.5 billion as a minimum. Major alternative uses of this amount of equity capital, or any portion thereof, are in Canadian firms undertaking fully-controlled Canadian ventures or by the proposed Canada Development Corporation - with the latter being, at least potentially, a means of mobilizing Canadian savings for more entrepreneurial-type

investments which could make a significant contribution to the economy. To some extent, however, this sum of equity capital could be mobilized by the foregoing of Canadian purchases of American equities - a possibility which is discussed below (see Capital Market) - the latter being a use of Canadian capital which is taking on significant proportions and which does not have any special growth-inducing effects for the Canadian economy. There are a range of other potential benefits and potential costs that are discussed elsewhere, so no definitive judgment on the merits of Canadian equity participation, in some form or other, is in order here. The important point in the present context is that the merits of any such proposal are increased to the extent that the foregone investment opportunities are not strongly growth-inducing and decreased to the extent that they are.

37. The net benefits from foreign investment can be elucidated by considering any specific empirical evidence on the contribution, respectively, of each of the advantages that Canada gains from foreign investment, namely, capital, technology (research and development), access to markets, and entrepreneurship. At the same time, in order to appraise the benefit from the foreign factors, consideration has to be

given to whether the domestic factors could have provided the same benefit.

38. The Canadian economy is highly capital-intensive, reflecting not only, in general, its advanced industrial character but also, in particular, its specialization in very capital-intensive kinds of resource development. Furthermore, the rapid growth and urbanization of the Canadian population in the past two decades has increased demands for capital, particularly for social overhead projects such as schools and highways. The overall level of Canadian savings, which constitutes the domestic supply of capital, reflects a Canadian propensity to save comparable with that of other affluent countries, and the machinery for mobilizing these savings, in the form of the institutions of the capital market, generally works well. The net result of an abnormally high demand for capital and an essentially normal domestic supply has been the large-scale importation of capital. The importation of capital could be dispensed with only by an increase in domestic savings of a significant amount, with a corresponding reduction in the present Canadian standard of living.

39. The feasibility of substituting domestic capital for foreign capital must make allowance for the fact that the latter includes direct investment which has

embodied in it, to some unknown but probably substantial extent, foreign technical progress, foreign entrepreneurship, and access to foreign markets. To put the matter differently, to dispense with foreign direct investment would require not only an increase in domestic saving, but also either obtaining access to other foreign inputs and foreign markets by routes other than the direct investment firm or providing the technical progress, entrepreneurship and markets from within Canada. In sum, any wholesale substitution of domestic for foreign capital over any short period of time is neither feasible nor desirable.

40. A closely related matter is that of the possibility of substituting debt for equity capital within any given level of Canadian reliance on foreign investment. Such a substitution is frequently advocated in Canada, reflecting a desire to obtain foreign capital without foreign ownership and control and a conviction that this benefit would exceed the risk assumed in substituting indebtedness with fixed terms of servicing and repayments for indebtedness subject to variable returns. But bond financing brings essentially capital, while equity capital brings a package including technology, management skills and market access. Attempts to shift foreign capital to debt rather than equity would need to be accompanied by alternative ways of developing in Canada or securing

from abroad the skills which accompany the latter. Moreover, the two forms of capital appear to draw on quite different sources of capital abroad, with bonds being held largely by American institutional investors and equity financing being accounted for largely by American corporations. Given these two constraints, substitution would appear to be feasible to any considerable extent only in the context where new institutions were created. For example, the Canada Development Corporation, in its original conception, would be able to undertake projects which would otherwise be done by direct investment firms. The Government of Canada could sell bonds to foreigners and invest the proceeds in the C.D.C. (For a more complete discussion of the C.D.C., see below Capital Market). In effect, this would mean substituting sales of bonds to foreigners for the foreign equity financing that would otherwise have taken place. The feasibility of this method would further depend on the willingness of foreigners to hold larger portfolios of Canadian bonds and the willingness of foreign governments to permit them to do so.

41. The tendency for American firms to engage in direct investment is correlated with their spending on research and development (R & D). By permitting of direct investment, other countries, including

Canada, gain access to the newest technology. While only a giant economy and super-power, such as the United States, is able to achieve technological leadership across a broad front, with all other countries experiencing a technological gap, leadership is possible in specialized areas if R & D spending is both large and appropriately allocated. Canada has been deficient in both respects, though less so in the past few years.

42. Canadian expenditures on R & D in 1963 were only 1.1 per cent of gross national product, a proportion below that of most countries of Western Europe and specifically below the 2.3 per cent for the United Kingdom (1964/65) and 3.4 per cent for the United States (1963/64). While both of these latter two countries have large military programs, with defence research expenditures accounting for 39 per cent of total R & D in the United Kingdom and 46 per cent in the United States in 1961-62, compared with 26 per cent in Canada (1961), allowance for this does not explain the deficiency in Canadian performance. Non-defence R & D is 0.7 per cent of gross national product in Canada (1961) compared with 1.5 per cent in the United Kingdom and the United States (1961-62), that is, Canada still ranks low, though to a lesser extent. By an alternative measure of R & D capacity,

the number of qualified engineers per 10,000 population, Canada's 7 (1963) ranks behind the United Kingdom's 11 (1964/65) and Japan's 12 (1963) and far behind Sweden's 22 (1964) and the United States' 25 (1963/64). By yet another criterion, the nationality of patent applicants, Canada's performance is particularly bad. In the period 1957-61, 95 per cent of all patents taken out in Canada were by foreign applicants and 69 per cent by United States applicants; corresponding figures were 47 per cent and 18 per cent for the United Kingdom, 59 per cent and 17 per cent for France, and 32 per cent and 12 per cent for West Germany. In no other country is the proportion of patents taken out by foreigners so high as in Canada, though ratios are increasing rapidly in other countries. If one looks only at industrial R & D the latter was 0.4 per cent of industrial output in Canada in 1963, compared with 3 per cent in the United States. Canadian university research expenditure was about one-fortieth that of the United States.

43. Within the context of relatively small overall spending on R & D, that of the Canadian government, supplying 54 per cent of all R & D funds in 1963, compares favourably with 57 per cent for the United Kingdom (1964/65) and not too unfavourably with the

United States government's 64 per cent. There is a sharp contrast, however, with respect to where government-financed research is conducted, with the Canadian government performing 79 per cent thereof and industry 12 per cent in 1963 (and the balance in institutions of higher education) compared with corresponding figures of 41 per cent and 48 per cent for the United Kingdom (1964/65) and 28 per cent and 54 per cent for the United States (1963/64). Government-sponsored research in Canada has been largely done intramurally, while support offered extramurally has been either for defense R & D by industry or for basic R & D at universities rather than for non-defense R & D for industry. The links between government and university research on the one hand and industrial research on the other appear not to have been as developed or as productive as in some other countries, though developments in Canada since 1963 would presumably show some improvement in this and other respects.

44. A possible explanation for Canada's overall deficiency with respect to R & D relative to most other advanced industrial economies is the unique extent of foreign ownership in Canada, with

subsidiaries having access to the technology of the parent, and a possible defense for the deficiency is that it is more economical to use foreign technology, albeit at some cost, than bear the higher costs of undertaking one's own R & D. There is statistical evidence to suggest that foreign-owned firms do relatively more research in Canada than resident-owned firms, even when allowance is made for the tendency of foreign firms to be concentrated in research-oriented industries. (See <u>Performance of Firms</u> below). It is probable that Canada benefits more from what it pays for foreign technology than it would for spending the same amount on R & D. in Canada. Furthermore, to increase overall R & D in an attempt to close the technology gap <u>across a broad front</u> would almost certainly be to waste effort.

45. A superior explanation of the Canadian deficiency, with implications for Canadian policy, is that the nature of Canadian society has not been conducive to the undertaking of R & D. The latter capacity is, like entrepreneurial ability, not a surface characteristic but rather is deeply rooted in society. The Canadian neglect of higher education in particular and the narrowly-based character of private and public élites in general

(see the discussion of entrepreneurship below) has both reduced the supply of scientists and engineers and, by lowering the quality of domestic managers and increasing the conservativeness of governments, decreased the demand for their service even more. In this context, the very ease with which Canada has been able to obtain technology through the route of the direct investment firm has reduced the pressure that might otherwise have been exerted, particularly on governments, to sponsor more R & D in Canada, including more industrial R & D performed by industry.

46. Policies directed toward improving the Canadian environment in the broadest sense might be expected to increase the capacity to do R & D in terms of both demand and supply, and in the long-run tend to generate Canadian technology that might supplant, but more probably supplement, foreign technology. Within that context consideration can be given to how best to allocate an increasing level of R & D; reasonable objectives would include strengthening traditional export industries, supporting industries which are predominantly domestic-owned so as to increase their efficiency

and to reduce the probability of foreign take-over, and insisting on Canadian benefit from government-subsidized research, that is, supporting firms without respect to ownership but requiring that any resulting innovation be exploited in Canada or the subsidy be repaid.

47. The practical efficacy of licensing arrangements and joint ventures as ways to obtain foreign techniques without foreign ownership are considered at length below (see Performance of Firms). Licensing agreements with foreign firms appear to be widespread in Canada, though many of them are agreements with affiliated firms, and to that extent are a supplement rather than an alternative to direct investment. It is believed that a number of these agreements contain prohibitions on rights to export, and it can be argued that the efficacy of licensing as an alternative to direct investment depends in considerable part on the removal of any such restrictions. Joint ventures proper, involving participation of two or more firms in another firm's capital stock, are not of much empirical significance at present

for Canada. There are only a small number of joint ventures between a Canadian firm and a foreign firm, and the great majority of these are small. The quantitative insignificance of joint ventures is symptomatic of the preference of the foreign firm for subsidiaries; while Canadian policy could be directed toward increasing their number, they do not appear to be an important alternative for Canada to direct investment.

48. The gaining of access to foreign markets is one of the benefits that is gained from foreign direct investment in the Canadian resource industries. A case in point is the Canadian iron ore industry, with exports accounting for 80 to 90 per cent of production, which has developed to its present position largely because of the need of United States' customers for assured supplies of iron ore to supplement their own domestic and other foreign sources. Because a steel plant requires an assured long-term supply of iron ore from a number of sources to maintain a uniform feed for blast furnace operations, major steel companies tend to participate in the financing of iron ore properties from which they draw their ore requirements in proportion to their participation

in the ore mining companies. It appears that some of the most important of the iron ore developments in Canada were unable to raise capital until long-term contracts existed with foreign buyers, and the foreign buyers insisted on ownership and control. Financial participation by foreign, and particularly American, steel companies assured Canada a share of the world iron ore market, and this appears to have been particularly beneficial in recent years in the face of a general over-supply situation in the world market. While not all cases are as clearcut as iron ore, it is probable that the provision of long-term assured markets is the most important benefit from foreign control of Canada's natural resources and that these market guarantees have permitted the development of natural resources that would otherwise not have taken place, at least as early as they did.

49. While it follows that independent Canadian firms would be, in general, an inadequate vehicle for developing Canadian resources, it does not follow that no scope exists for increasing Canadian benefits. Exports are tied to the fortunes of particular companies and particular

countries. There is empirical evidence that the export performance of a country in a particular commodity depends on the particular institutional arrangements for marketing that commodity. Access to markets is sometimes obtained through long-term fixed price contracts; despite their obvious advantages in other respects, they constitute a means of keeping profits normal on a rising market. Further, since foreign owners of Canadian firms operating in the natural resources sector appear often to have considerable influence over the determination of world prices, no independently determined fair market value exists which Canadian tax authorities can use to check intrafirm transactions in order to minimize profit shifting and tax liability.

50. It is obvious that Canadian benefit is increased by proper taxation of returns to foreigners. It is distinctly possible that Canadian benefits would also be increased by Canadian equity participation as a device to assure direct sharing in profits. A large resource development often involves the creation of a consortium representing a number of foreign firms; the latter are necessary for markets to be

assured, but there may well be possibilities for minority Canadian participation, for example, by the Canadian Development Corporation. Indeed, the initiative for organizing the consortium might be taken by the C.D.C. The object would be primarily participation in profits, but if some increased Canadian control in natural resources resulted it would be a valuable by-product.

51. Foreign direct investment, involving as it does the geographic extension of the firm, brings with it entrepreneurship, or management drive and skill. It is possible that it is this component of direct investment that is most difficult to obtain from abroad by alternative means. Its general importance in underlying the process of foreign direct investment is made particularly evident when foreign take-overs result, as they sometimes appear to, simply from the conviction of the management of the foreign firm that it can outperform the old management. At the same time, extensive reliance on foreign entrepreneurship, as in Canada, must also be seen as reflecting deficiencies in the Canadian environment. To some extent, management skills can be formally taught; in Canada, the gap in the formal education of the

managers of Canadian firms, relative to those of firms in the United States, is greater than for any other major occupational group.

52. Underlying this specific deficiency, but having more pervasive consequences for Canadian entrepreneurship and innovation, has been the nature of the Canadian social structure and the consequent climate of enterprise. Evidence on the background of resident entrepreneurs suggests that they have been drawn from a too limited and homogeneous part of the population. A relatively small élite has exercised economic and political control - to the extent that control is exercised within Canada - and the result has been a less open and mobile society than is consistent with the optimal development of Canadian entrepreneurship. If the full range of sources of entrepreneurial talent is not being exploited in Canada, and if this is less true in the United States, the implications for resident versus non-resident initiatives in Canadian development are obvious - as is the direction of the remedy.

53. Finally, the Canadian tariff and the extent of foreign control - and perhaps particularly the

combination of the two in creating inefficient production by subsidiaries - have, over the decades, narrowed the horizons of Canadian managers and reduced the scope for decision-making. Entrepreneurship is partly a learning process, and the essence of learning is doing.

54. A judgment of the net benefit from foreign investment required consideration of the costs of foreign capital. The most obvious is the payment of interest, dividends and business services of various kinds to non-residents. Interest and dividends paid abroad have risen absolutely in recent years until they exceed $1 billion per year. As a percentage of national product, however, they have tended to be relatively constant in the last decade or two and are lower than in previous periods of heavy capital inflow in this century. From the viewpoint of the economy as a whole, then, they are not becoming more burdensome. No historical measures are available of business services paid abroad, and in any case it appears that many firms prefer to take these in the form of profits rather than direct payments; a recent estimate for 266 large firms owned by non-residents shows direct payments abroad for business services of $250 million.

These direct costs might also be judged by examining the profitability of non-resident-owned firms compared to resident-owned firms, since significantly higher profits by the former, being ultimately paid to foreigners, would indicate that the costs of foreign capital may exceed those for domestic capital. Such data as exists on comparative profitability suggest that in the aggregate there is not a significant difference in profitability of non-resident owned firms and resident-owned firms, though for a number of industry groupings within secondary manufacturing, profits appear to be higher for non-resident owned firms.

55. There is a cost involved in living in a more international economy, namely, to so order a country's policies as to maintain equilibrium in the balance of payments. A country which engages in foreign trade, for example, secures the benefits of specialization but may also have to face instability in its exports and pressure on its balance of payments and domestic income. Similarly, instability in the flow of capital imposes certain costs. If the instability is short-lived, it can be handled by changes in foreign exchange reserves and monetary policy. In some cases it may require changes in

the exchange rate as well, or even direct controls. In cases of extreme or prolonged instability, as in the 1930's, substantial changes in the prices and incomes of the factors of production and of their allocation by industry will also be necessary. The point is that the policy changes necessitated by instability in capital inflow may not be those desirable for internal equilibrium of income, employment, or prices at any given time.

56. In addition, a country must adjust its policies to ensure that domestic plus foreign-owned industry together create sufficient foreign exchange over time to finance the income transfers abroad and any repatriation of foreign investment. The implications of foreign investment for the balance of payments are discussed at length below. In general, the mechanism of adjustment in the Canadian balance of payments works well. The foreign exchange crisis of 1962 is more clearly attributable to government mismanagement than natural economic forces. The openness of the Canadian economy, in terms of both trade and capital movements, requires constant attention to the balance of payments and may limit the use of monetary-fiscal policy to affect domestic income

and prices, though it is likely that this would be less true under a flexible rather than fixed exchange rate system. The interdependence of the Canadian and American economies means that balance of payments problems in the latter impinge on the balance of payments prospects and policies of the former, as in the United States balance of payments guidelines to parent firms and the ceiling on Canadian foreign exchange reserves in return for exemption from the Interest Equalization Tax. From a long-run perspective, persistent dependence on capital inflow has not precluded a viable balance of payments, though this has been achieved too much by inefficient import-replacement and too little by efficient export-creation.

57. In the face of inappropriate industrial policy, the gains from foreign direct investment may be dissipated, or the economy saddled permanently with inefficient use of its resources in high-cost industries. There is no doubt that this has happened in some sectors of secondary manufacturing dominated by foreign-owned firms. An uneconomic proliferation of firms and of products has prevented the development of industries which are efficient by world standards. The Canadian tariff is intimately linked with the

decision to locate in Canada for many firms, while it has also made it attractive to produce short-runs in Canada and thus helped prevent the attainment of efficient scale. The subsidy to particular producers involved in the tariff is usually justified on the grounds that the subsequent efficient development of the firm will compensate society for the subsidy. This has frequently not happened, and the result is a loss to Canada in the form of a subsidy to foreign shareholders. This loss has to be offset against the gains from foreign investment. Foreign tariffs and private restrictions on trade have also limited the attainment of efficient scale. Furthermore, the perpetuation of imperfectly competitive or oligopolistic market structures, both imported and domestic, limit the possibilities for rationalization of industry through competition. The dissipation of the gains from foreign investment in these ways results, however, in considerable part from inappropriate industrial policy in Canada and between Canada and other countries; the cost, then, is the loss of the benefit that would be achieved if firms operated in a better public policy environment.

58. For a country to gain the most from foreign investment, the benefits should exceed the costs by as much as possible. Put this way, and considering the qualitative nature of many of the benefits and costs, it is clear that no precise measure of net economic benefit is possible. Given certain assumptions, a numerical calculation can be made of the net benefit, as was done above. While this has value in indicating orders of magnitude, the most important conclusion that has emerged from the preceding discussion is that whether overall net economic benefits are large or small depends critically on how successful is domestic policy in increasing benefits and decreasing costs.

Performance of the Canadian Economy

59. Any judgment about the contribution of foreign investment to Canadian economic growth needs to be set in the context of the actual performance of the Canadian economy. The growth of Canadian national product in the long-term compares very well with that of other industrial countries, exceeding all but Japan and the United States. Long-term growth in output per capita also compares well. Comparisons for various periods since 1945, however, are not as favourable to Canada. For the decade 1955 to 1965, the overall growth rate ranks ninth, in descending order, among fourteen industrial countries, and the growth rate per capita ranks thirteenth. Such short-term comparisons are affected by the years chosen, and particularly in this case by the slow growth of the Canadian economy in the late 1950's and early 1960's, but other postwar comparisons are also not very favourable to Canada. If one looks only at Canada and the United States, the increase in real income per capita has been about the same for the present century. There has been a

relatively higher rate of growth in overall output in Canada, but also in population. The result has been that the national product per capita has remained at about 75 per cent of the United States level both in the early years of the century and today.

60. Can the Canadian growth rate be deemed adequate in view of the favoured access Canada has had to foreign capital and technology compared with other countries? Any answer to the question is necessarily speculative. One cannot know what the growth rate would have been with a different set of policies toward foreign investment designed to increase net economic benefit, nor are international comparisons of growth rates always meaningful in view of the widely different settings of the countries involved and the quality of the statistics. Nevertheless, it is useful to ask how far and in what ways foreign investment is both necessary and sufficient to the growth process.

61. That it is not sufficient is clear.

There are many variables involved in the growth process, and many of these are entirely or largely internal; ultimately, development is made at home. Indeed, if the country involved fails to exert itself in improving domestic sources of growth, and fails to provide a proper growth-orientated set of policies within which entrepreneurs in general operate, then it cannot realize all of the potential gains from either its own factors or from foreign investment. While business provides on-the-job training and tax revenue, for example, it contributes relatively little directly to filling the large gap in formal education between Canada and the United States - a gap which is important in explaining the differences in real per capita income between the two countries.

62. It is easy to use foreign capital and technical inflows as a crutch, and in the process avoid doing the many things required to mobilize and effectively use internal sources of saving, to develop and apply the best technology, and to provide sufficient entrepreneurial and labour skills; Canada has

not been guiltless in these respects. Moreover, an important aspect of productivity change lies in organizational changes with respect to production and distribution, economies of scale, and efficient resource allocation, all of which assume a set of policies designed to give maximum efficient growth. Canadian policies with respect to industrial organization in Canada have emasculated some of the benefits of the multi-national corporation. The transfer of technical benefits has been dissipated in many areas of secondary manufacturing because of an inefficient structure of industry, resulting from tariff policy here and abroad and the lack of effective competition.

63. Not only is foreign capital not sufficient to rapid growth, it is not necessary to rapid growth at all times or in the same ways and amounts. The experience of other developed and open economies shows that rapid growth has often been achieved with capital inflows playing a relatively much smaller role than in the case of Canada, or with relatively less direct investment, or with emphasis on technical transfers rather than capital. This is not to

deny that, at full employment, a country can achieve a faster rate of growth by foreign borrowing - except possibly in some enclave economies where the gains flow entirely abroad. Rather, it is to suggest that, at any given growth rate, both the overall need for and desirable type of access to foreign capital and technology will vary with the extent to which domestic sources of capital and technology have been developed and with the nature of domestic policies, especially with respect to industrial structure.

64. It is in these latter respects that there is room for improved Canadian performance which ought then to improve the performance of the economy. In fact, Canada's overall dependence on foreign capital relative to total Canadian capital formation has declined from the first decade of the century to the third to the seventh as domestic sources of saving have expanded. The decline could continue, especially as private and public means for mobilizing and directing savings to investment continue to increase and become more

sophisticated in the tasks they can undertake. Canadian dependence on foreign technology has been substantial throughout the process of industrialization and will remain so. Nevertheless, efforts made now to develop more of the skills involved in Canada would supplement, and in some cases supplant, inflows of foreign direct investment. Canadian policy to encourage the development of manufacturing has increasingly shown concern with the efficiency of what has been created, as is evidenced in Canadian willingness to participate in multilateral tariff cuts and in Canadian initiatives to rationalize Canadian industry, but there remains considerable scope for policies that will compel competitiveness and efficiency, and in the process, increase the net benefits from foreign ownership.

65. The contribution of the Canadian tariff to Canadian economic growth deserves special comment, both because a protective tariff was at the heart of Canada's historic National Policy and because free or freer trade is being advocated with increasing frequency in Canada. Historically, the Canadian economy has developed in the face

of external demands for Canadian primary products and external supplies of labour and capital. The contribution of the protective tariff is probably to have increased the size of the Canadian economy, in terms of population and gross national product, by expanding job opportunities in secondary manufacturing. It has almost certainly increased the extent of foreign ownership by causing foreign firms to substitute Canadian production for exports. Because many of the tariff-protected industries have not become efficient, even in the long-run, it is probable that the Canadian tariff has reduced real per capita income to below what it would be under a more appropriate tariff policy.

66. The case for tariff reduction is presumably strong on grounds of economic efficiency. It would facilitate the rationalization of many existing firms, and in other cases, replace inefficient Canadian production with imports and encourage resources employed in these industries to shift to more productive employment. The extent of the increase in consumer welfare, however, depends on the extent to which prices fall; that, in turn, depends on the absence of collusion

among producers, whether domestic or foreign. While the Canadian tariff facilitates collusion and non-price competition (see below Structure of Industry), tariff reduction complicates, but does not preclude, collusion among foreign producers to maintain import prices or collusion among Canadian firms when the latter include among the dominant firms subsidiaries controlled by foreign producers. Tariff reduction ought, then, to be accompanied by policies to increase domestic competition and, through international cooperation world competition.

67. The effect of tariff reduction on the population-sustaining capacity of the Canadian economy is more problematic. Tariff reduction ought presumably to be accompanied by vigorous efforts, both to maintain employment and permit of the continuing absorption of immigrants, involving monetary-fiscal policies and adjustment assistance in the short-run and policies designed to increase the quality of Canadian inputs, and hence the capacity of Canadian output to face world competition, in the long-run. Tariff reduction, and nothing else, might significantly

increase economic efficiency in individual industries, but it is by no means certain that it would increase the rate of growth of gross national product.

68. Though the tariff has probably increased the extent of foreign ownership, it is not clear that its reduction would lead to any substantial reversal. While some foreign firms attracted by the Canadian tariff might now choose to close down, it is more likely that most foreign firms would rationalize their Canadian operations within the structure of the multi-national enterprise. To the extent this happened, foreign ownership would be unchanged, and foreign control, not in the legal sense, but in terms of the extent to which the Canadian subsidiary was permitted autonomy in decision-making, might even increase.

69. While this is a distinct possibility with respect to existing firms, it is less certain with respect to new foreign direct investment. With lower tariffs, there would presumably be less development based on the past pattern of inefficient import-substitution and more based

on efficient export-creation. The old pattern was closely linked to foreign ownership. The new pattern could be more allied to resident ownership, if the quality of Canadian inputs does improve significantly in the future. Tariff reduction, and nothing else, risks increasing effective control within existing direct investment firms and provides no definite assurance that future investment will be more under Canadian control.

70. Tariff reduction ought presumably to be accompanied by policies designed both to offset any erosion in private decision-making in Canada - by increasing public surveillance of the Canadian operations of foreign firms and by a more active government pressure in decision-making - and to increase the quality of future Canadian inputs so that the probability of Canadian ownership of future investment will be increased. The tariff is one of the few instruments available to the government at the present time for controlling the structure of Canadian industry. This explains its use despite its inefficiencies. Reduced reliance on the tariff to control Canadian

development implies the creation and utilization of other instruments for effecting government policy.

Conclusion

71. Foreign direct investment makes a positive contribution to Canadian economic growth by creating economic benefits for Canada. But foreign investment also creates costs. For Canada to gain the most from direct investment, the benefits should exceed the costs by as much as possible. Whether the overall net benefit is large or small depends critically on how successful Canadian policy is in increasing benefits and decreasing costs. The net benefit to Canada could be increased

- by increasing the competitiveness of the Canadian economy so that the benefits from foreign direct investment are not emasculated through its inefficient use

- by using the Canadian tax system and Canadian participation in ownership as means to increase the Canadian share of the benefits from foreign direct investment

- by improving the quality of Canadian factors of production, particularly Canadian entrepreneurship, so that foreign firms operating in Canada will be challenged by high standards of performance of Canadian-owned firms.

iii. Structure of Industry

1. An evaluation of the benefits and costs of foreign direct investment must be made with reference to the structure of Canadian industry and the competitiveness of the Canadian economy. The performance of the economy as regards both efficiency in the use of resources and the rate of technological progress is related to market structure. When market structure is characterized by a relatively large number of firms actively competing with each other, the discipline of the market compels efficiency and facilitates progress. The market decentralizes decision-making and diffuses power.

2. The presumption in favour of more rather than fewer firms does not mean, however, that big firms with market power need not nor should not exist, or that it is not possible to have too many firms in an industry for the public good. The former depends on the reason for bigness, for example, whether it is based on technological economies of scale or on the pursuit of monopoly power for its own sake, and on the nature of the competition among the dominant firms, or oligopolists. The latter depends on whether the (small) firms are

of a size and organization consistent with optimal efficiency, for example, large enough to take advantage of economies of scale and organized for long production runs, and on whether they do, in fact, actively compete among each other.

3. While policy must vary with circumstances, the overriding presumption is that it should be directed toward the maintenance of competition, in terms both of the numbers of firms and their performance. Bigness and market dominance can be countered by nationalization, supervision and regulation, anti-combines and anti-merger policies, and low tariffs to create import competition. Smallness and inefficiency can be countered by industry rationalization programs and, again, import competition. Economic growth itself, since it takes place in part via the emergence of new firms, creates the possibility of an increasingly competitive market structure though other forces - of which the two most relevant for this Report are foreign ownership and Canadian policy - may reinforce or hamper such a development.

Bigness and market dominance

4. Most western industrial economies are, in fact, characterized by giant firms and by high levels of concentration in a number of sectors and industries. Canada is no exception. A small number of giant firms dominate the Canadian economy in quantitative terms. One source of information on the size of firms is aggregative statistics based on returns filed under the Corporations and Labour Union Returns Act (CALURA). The total number of such firms in 1963 was 26,643. (The data exclude banks, insurance companies, trust companies, and certain other financial institutions, as well as railways, crown corporations, and certain other companies. They also exclude unincorporated firms, and small companies with annual gross revenue less than $500,000 or assets less than $250,000. The returns of subsidiaries are not consolidated with their parents). There were 101 giant firms with assets of $100 million or more. These firms, though less than .5 per cent of the number of firms, accounted for 32 per cent of the assets of all firms. There were 414 firms with assets of $25 million or more; these firms, being less than 2 per cent of the number of firms, accounted for 53 per cent of the assets of all firms.

5. A second source of information on the size of firms is aggregative statistics based on tax returns. Data for 1964 on "Fully Tabulated Companies" — which excludes banks and insurance companies — shows that 162 companies, or .1 per cent of the companies had an asset size of $100 million or more and accounted for 41 per cent of the assets of all companies, while 560 companies, or .4 per cent of the companies, had an asset size of $25 million or more and accounted for 57 per cent of total assets. Tabulations on current profits before taxes show that .1 per cent of the firms having profits of $5 million or more earned 38 per cent of reported profits, while .4 per cent of the firms having profits of $1 million or over earned 57 per cent of reported profits.

6. A special attempt was made to compile a list of the largest Canadian companies. The identification of the companies permits of statistical analysis of foreign ownership ratios (see below) and the proportion of private companies (see a number of places above and below) not otherwise possible. The existence of the private company, which is not required to disclose

financial information to the public (see below, Performance of Firms) among the giant firms precludes drawing up a complete list of the names of such firms. The list compiled contains 536 large companies for which ownership could be determined. According to taxation statistics, there were 560 firms with reported assets of $25 million or more in 1964; neither the listing nor taxation statistics includes some 50 banks and insurance companies with assets exceeding $25 million. The identified companies represent about 95 per cent of the total assets and profits of all companies - other than banks and insurers - of this size. The list further contains 207 smaller companies, giving a list of 743 of the largest Canadian companies. Of the 536 larger companies, 128 are wholly-owned subsidiaries of other of the large corporations or of the parents of the large corporations, leaving 408 corporate complexes. In addition, of the 207 smaller companies, 70 are subsidiaries of these large corporations. The 408 corporate complexes (including their 198 wholly-owned subsidiaries, or 606 separate companies) have in the aggregate reported assets of about $53 billion and total profits before tax exceeding $2 billion. These

amounts represent almost 55 per cent of total corporate assets and a slightly smaller percentage of total corporate profits for the year 1964.

7. An attempt has been made to collect detailed financial data on 570 of the 606 separate companies, the excluded companies being mostly financial corporations. These 570 companies had 46 per cent of the assets of all fully tabulated companies in 1964, 35 per cent of the sales, 53 per cent of the taxable income, paid 67 per cent of the dividends and accounted for 51 per cent of the net internal cash flow. These large companies are a very dominant factor in three sectors of the Canadian economy - mining, quarrying and oil wells, manufacturing and utilities - significant in two sectors - retail trade and finance - and occupy a relatively small role in four sectors - agriculture, forestry and fishing, construction, wholesale trade, and services. The 319 of these companies which are in mining, quarrying and oil wells and manufacturing accounted for about two-thirds of total assets, current year profits and internal cash flows in these two sectors. Finally, of these 570 corporations, 221 are private companies which, when consolidated, make up 169 private corporate complexes.

8. The extent to which a small number of large firms dominate particular industries can be ascertained by calculating concentration ratios, that is, the percentage of an industry's employment (or sales, or value of shipments) accounted for by a given number of firms. A comprehensive private study for the year 1948 shows that in half of a large sample of industries, nine firms or fewer in each case accounted for 80 per cent of employment. Most of the industries based on metals, chemicals and non-metallic minerals had still higher concentration while most of the industries in the wood, paper, textiles and clothing groups had lower concentration. Food processing industries contain examples of both very low and very high concentration. In retail trade, wholesale trade, and services, while there are well-known examples of giant corporations, small firms are the dominant form of business. Agriculture, too, is still in the main a small business area. In the field of transportation, communication and storage, concentration is much higher and giant firms dominate, but many of the largest firms are government-owned. Large government-owned and private units also dominate

the urban transit field. In the pipeline business, concentration is high and giant firms are of major importance. The financial sector of the economy is marked by large firms and high levels of concentration in its major branches, particularly commercial banking and life insurance. The most important branches of mining, metal mining and petroleum production, have output concentrated in large integrated firms. Public utilities are traditionally the domain of large firms and high concentration, but in electric utilities firms are largely government-operated.

9. Thus, many individual lines of business are substantially controlled by large corporations, and in many more, markets are controlled by just a few sellers, who may not be corporate giants. The situation appears to have changed little over the last decade. A study of changes between 1954 and 1964, based on the compilation of individual company records, shows no clear trend towards increasing or decreasing concentration. For 21 industries, 8 industries show increasing concentration, in 8 others there is decreasing concentration, and in 5 the level of concentration has remained about the same. Problems due to

"bigness" in business, problems due to extreme inequality of firm size, and problems due to monopolistic control of markets by a small number of sellers are therefore of major importance in the Canadian economy.

10. The causes of bigness and market dominance are complex and various, but a three-fold classification is possible, namely, economies of large-scale production, economies of large-scale sales promotion, and absolute cost advantages. Economies of large-scale production result when, for essentially technological reasons, large plants have lower production costs per unit of output than small plants. These production economies of scale, however, are likely to occur only up to a point in the growth of the plant; beyond some minimum optimal scale, further increases in plant size will not result in further increases in efficiency. The output capacity of plants of minimum optimal scale varies widely among industries, depending on the character of the production techniques used in each industry. While economies of large-scale production help to explain bigness of firms, it is not true that economies of large-scale production continue to be reaped indefinitely as size grows.

11. Nor are economies of large-scale production the only reason for bigness. Where economies of large-scale exist, they may not be related to production but to sales promotion. Large-scale sales promotion economies are most likely to occur where firms operate in large markets and confront consumers whose tastes can be moulded and manipulated by such means as heavy advertising expenditure, frequent styling changes, multiplication of product models, or the financing of dealer-service networks at the retail level. However incurred, large-scale promotion costs result in many industries in a much larger size of firm than could be explained by production economies of large-scale.

12. As well as these two varieties of economies of scale, the growth of large firms can result from absolute cost advantages for established firms in a given industry relative to potential entrant firms. An absolute cost advantage exists when the established firm's unit costs of production and physical distribution are lower than those of prospective entrant firms generally and more or less at any common scale of operation. The advantage of the established firm can rise from many sources - easier access to capital, ownership

of essential raw materials, sole rights to patents. An important means by which an absolute cost advantage can be created and barriers to potential entrants raised is vertical integration, that is, the vertical growth of the established firm via integration of preceding or succeeding productive processes. While some vertical integrations are cost-saving, others primarily create absolute cost advantages which can have a significant effect in raising the minimum optimum size of firm in a given industry.

13. Important implications for economic welfare, and hence for policy, follow directly from this analysis. In industries where the advantages of large firms result primarily from production economies of large-scale, the reduction in unit costs is likely to make the consumer better off, provided that it is passed on to consumers in the form of lower prices. In industries where the advantages of large firms are related mainly to economies of large-scale promotion, the consumers benefit on the assumption that the pattern of seller behaviour is fixed - that is, that competition between sellers must necessarily take the form of attempts by individual firms to differentiate their products and manipulate

the consumer by means of various sales promotion techniques - and that large firms are more efficient performers within this pattern and pass on the benefits to consumers in the form of lower prices. On the other hand, if the pattern of seller competition based on product differentiation is not assumed to be fixed, then consumer welfare might be increased if sales promotion costs in these industries were reduced and the costs savings passed on to consumers in the form of lower prices. Furthermore, the reduction of competition based on sales promotion, by lowering the minimum optimal scale of firms, would make entry of new firms easier and increase competition. There are limits to this process, however, to the extent that consumer welfare is enhanced by some degree of product differentiation not related to excessive sales promotion. In industries where the presence of large firms is related mainly to absolute cost advantages arising out of vertical integration, the consumer is better off if this results in greater efficiency and lower prices. On the other hand, where this is not so, consumers might be made better off by the vertical disintegration of established firms which would increase the number of firms,

lower barriers to entry, and increase competition. An important exception, however, is the case of vertically-integrated export industries, as in the resources sector, where adverse effects arising from monopoly power may be borne by foreign buyers and higher prices may raise the benefit to Canadians.

Foreign Ownership and Tariffs

14. This classification of the causes and consequences of large firms in Canada must make allowance for two important and interrelated phenomena: non-resident ownership and control of many large Canadian firms, and Canadian and foreign tariffs. The large and dominant firm with the cost advantages may be foreign owned. Already large by Canadian standards, there stands behind it a much larger parent. This has three important implications for the analysis to this point. First, if the large firm is more efficient but this does not lead to lower prices, then the foreign shareholder benefits rather than the Canadian consumer, except to the extent that profits accrue to Canadians through taxation or equity participation, or are absorbed by increases in wage rates. Second, large oligopolistic firms, once established in a market, tend to have staying power. If these firms are foreign-owned, then the potential for entry of late-coming Canadian firms is reduced. Third, to the extent that foreign ownership becomes pervasive, foreign structures of industry and patterns of behaviour tend to be built into the economy of the host

country. The extent of American investment in Canada tends to implant, or reinforce, the American industrial system in Canada. The need for vigorous policy to promote competition is increased, but the effectiveness of national policy is reduced.

15. Foreign tariffs reduce the size of the market facing (efficient) Canadian firms by inhibiting Canadian exports; their lowering would facilitate Canadian manufacturers attaining efficient scale without destroying rival firms and would reduce the incentive for firms to collude in Canada. The Canadian tariff induces firms to produce in Canada, including foreign firms, but not necessarily efficiently, even in the long-run. New entrants into a tariff protected industry have a choice between entering with a plant of low-cost optimum scale or on a scale that is less than optimum. Since entry at a large efficient scale might result in protracted and costly price wars, the new entrant opts for the higher costs of small scale and maintains prices at the level set by established firms. Such collusion and high prices is possible because the domestic industry is protected from the competition of more efficient foreign production.

Thus, the high price possible because of the Canadian tariff both provides an inducement to entry and permits entry at inefficient scales. Hence the paradox that industries which are, from the perspective of maintaining competition, characterized by large and dominant firms reluctant to compete with respect to price, also are, from the perspective of efficiency, characterized by the overcrowding of sub-optimal firms - an outcome that might be thought to be the worst of both worlds. The reduction of the Canadian tariff would reduce inefficiency by increasing import competition, lessening the number of Canadian firms and rationalizing production within the remaining firms.

16. Whether firms are Canadian-owned or foreign-owned is important. If the new entrant is a subsidiary of a foreign corporation, there is a further choice as to whether to produce the full-line of the parent in Canada or specialize the subsidiary's production within the multi-national firm. Tariffs inhibit the choice of the latter, thereby leading to short-production runs and frequent change-overs which increase costs. This tendency of the tariff to limit the extent

of specialization by firms appears to be an important and pervasive factor adversely affecting costs and productivity in manufacturing in Canada. Rationalization in the face of tariff reduction would be facilitated by the existence of the multi-national firm, though benefits to Canadian consumers might increase less than they should because of international collusion, and costs might be incurred in terms of a shift outside Canada of more of the decision-making within the multi-national firm. (See above, <u>Sources of Economic Growth</u>).

17. An attempt has been made to assess empirically the role of non-resident firms in the Canadian economy, with respect to size of firms and contribution to industrial concentration. It is widely believed that foreign-controlled firms in Canada are larger than domestic firms. This impression is confirmed by data compiled under CALURA. Well over half of the assets of foreign-controlled firms - the criterion used being foreign ownership of 50 per cent or more of the voting stock - is, in 1963, in companies each having net assets of over $50 million and over two-fifths are in companies each having net assets of over $100 million. By contrast, among domestically-owned

corporations, only just over one-third of the assets are in corporations each having net assets of over $50 million and just over one-quarter are in corporations each having net assets of over $100 million. Among the larger corporations, well over half the assets are in foreign-controlled corporations, while among smaller corporations the proportion of foreign-controlled firms is much smaller: the proportion of assets in foreign-controlled corporations rises with the size of the corporation until the latter reaches $25 million, but not much thereafter. Balance of payment statistics on foreign ownership and control - which, unlike CALURA, consolidate related companies in Canada - show much the same results. In 1960, about two-thirds of the capital of foreign-controlled enterprises is in large firms with more than $25 million capital each. The proportion is considerably higher for firms in petroleum and natural gas as well as mining and smelting, and considerably lower for firms in the merchandising, financial and service sectors. Well over half of the manufacturing activity in large enterprises is foreign controlled, and not much less than one-half is United States controlled. This striking difference in size between domestic

and foreign firms is not entirely a matter of "industry mix", that is, it does not appear to result simply because foreign firms happen to predominate in industries characterized by large firms for reasons other than nationality of ownership. Of 81 narrowly defined manufacturing industries in 1963, 66 show a larger average firm size for foreign-controlled firms than Canadian firms, 13 show a larger average firm size for Canadian firms and in 2 industries average firm size is about the same.

18. Using CALURA and other data, an attempt has been made to classify the ownership of 743 of the largest Canadian corporations. It is estimated that 380 are foreign controlled and 363 Canadian controlled. Slightly more than half of the pre-tax profits of these companies accrued to the foreign-controlled companies. Of the 380 foreign-controlled firms, 99.9 per cent to 100 per cent of the profits accrued to non-residents for 221 of these firms. Of the 743 firms, non-residents derive 50 per cent or more of the profits for 381, or more than half of them. Of the 74 of these firms in mining, quarrying and oil wells, 47 are foreign controlled; of the 351 firms in manufacturing, 221 are foreign

controlled. In contrast, of the 155 firms in finance, 106 are Canadian controlled.

19. There is a correlation, when different industries are compared, between the proportion of an industry's business that is foreign controlled and the degree to which output is concentrated in a few firms. In terms of broad sectors of the economy, it is known that agriculture, construction, services and trade have predominantly low concentration and a low proportion of foreign control, while manufacturing, mining, smelting, and oil refining have both high concentration and a high proportion of foreign control. But there are exceptions to this correlation at the sectoral level, with both utilities and railways having high concentration and a low proportion of foreign control. A more detailed analysis made for eighteen of the twenty largest manufacturing industries, compares the ranking of industries according to degree of foreign control (from balance of payments data for 1961) with the ranking of concentration ratios in Canada (1948) and the United States (1963). In both cases the rankings are correlated, that is, foreign ownership in Canada tends to be associated with a concentrated industrial structure in both Canada and the United States. When industries

are grouped according to the degree of foreign control and matched with their relevant median concentration ratios, there is a tendency for the medians to fall with declining foreign control. Both high concentration and a high proportion of foreign control are characteristic of motor vehicles, petroleum refining, smelting and refining, and industrial chemicals. There are, however, exceptions to this association between foreign control and concentration, of which the most important are iron and steel mills, and slaughtering and meat packing, both of which have high concentration and low foreign control. A correlation between industrial concentration and degree of foreign control has also been found for other countries. In sum, foreign control tends to concentrate in the leading firms in Canadian industries. This is not to say that industries are concentrated simply because of foreign control. Rather it may be that foreign direct investment goes substantially into industries which are concentrated because of economies of large scale and absolute cost advantages.

20. The relationship between concentration and foreign control can also be examined by

defining foreign control not in terms of the proportion of an industry's total business carried on by all foreign-controlled firms but by the number of foreign firms among the industry's largest firms. On the basis of CALURA data for manufacturing, the degree of concentration has been measured by the percentage of the industry's sales in the eight largest firms. Where the eight firms accounted for 90 per cent or more of sales, on the average 4 were foreign controlled and 2 were United States controlled. The corresponding figures for 70 to 89 per cent of sales were 5 and 4; for 40 to 69 per cent of sales, 4 and 3, and for under 40 per cent of sales, 4 and 3. Thus, the incidence of foreign control of the largest firms is exceptionally high with "medium-high" concentration of 70 to 89 per cent, while, in the most highly concentrated industries, the incidence of foreign control is no higher than in the industries with low concentration. For United States-controlled firms among the leading eight, their number is exceptionally low in the most highly concentrated industries and, again, exceptionally high in the industries with "medium high" concentration. When other sources of data are utilized to correct the deficiency of CALURA

in not consolidating parent and subsidiary, what is evident is a great deal of variety in the role of foreign-controlled firms among the Canadian giants (mostly firms with assets of $100 million or more). Foreign firms have over 90 per cent of the assets of all leading firms in petroleum products, tobacco, rubber, aircraft, and automobiles, and between 50 and 90 per cent in chemicals, mining and smelting, and electrical products. In contrast the percentage of foreign control is very low among the leading firms in cotton goods, structural steel, cement products, transportation industries, utilities, banks, trust and mortgage companies, and is a little higher, but still very low in food industries, insurance, alcoholic beverages, steel, and telephones. One inference from these findings is that, while foreign control tends to concentrate in the leading firms of those industries in which foreign direct investment is substantial, this tendency does not depend on the relative share of total output controlled by the leading firms. Furthermore, the correlation between concentration and foreign ownership does not preclude the existence of leading firms, and giant firms, which are Canadian-owned.

21. While no clear trend is discernible over time with respect to the concentration ratios, as was noted above (para.17), there is a predominant, though not a very pronounced trend, towards a decrease in the relative importance of foreign-controlled firms among the leading oligopolists. As measured by the proportion of foreign-controlled assets among the assets of the leading 4 firms and the leading 8 firms, respectively, there is a decrease in the relative importance of foreign control in 9 industries, no significant change in 9 others, and and increase in only 3 cases. Decreasing foreign control among the oligopolists is found both in the industries in which concentration is increasing and the industries in which concentration is decreasing but, on the basis of a count of industries, it is slightly more important in the industries in which concentration is falling. The industries in which there is no significant change in concentration are typically also industries in which there is no significant change in the importance of foreign control among the leading firms.

22. The acquisition of firms through merger is a means by which dominant firms emerge and then maintain their position, and hence keep concentration ratios high, and also a means by which direct

investment can take place, that is, the take-over of a Canadian firm by a foreign firm. While not much is known about mergers in Canada and, in particular, no empirical study exists on the causes and consequences of foreign take-overs, an attempt has been made to investigate whether foreign-controlled firms have a greater tendency to acquire others through merger than domestically-controlled firms. (Comprehensive information on mergers for the years 1945 to 1961 was collected under the Combines Investigation Act. Merger activity on the part of acquiring firms is measured by the total assets of the acquired firms. To determine whether merger activity is disproportionately high or low, it is related to capital invested, as used in the statistics on Canada's international investment position, by foreign and domestically controlled firms respectively). On the basis of tentative findings, it would appear that, for the period as a whole, Canadian firms were responsible for a disproportionately low amount of merger activity and foreign firms as a whole for a disproportionately high amount of merger activity. Since it does not appear that United States-controlled firms were responsible for an exceptionally high proportion of merger

activity, the inference is that firms controlled overseas have been responsible for a disproportionately high share of merger activity. In manufacturing the proportion of merger activity by Canadian-controlled firms is about equal to their relative importance in the economic sector, that by United States-controlled firms lower, and that by firms controlled overseas higher. In the petroleum and natural gas industries, mining, and merchandising, the Canadian share of merger activity is low, and the United States share is high. The overseas share is disproportionately low in mining and high in merchandising.

23. As industries expand, there might be expected to be a tendency towards an increase in competition through the entry of more firms of efficient size. But this will not happen to the extent that there are high barriers to entry because of the advantages, real or contrived of established oligopolistic firms or to the extent that merger activity by the oligopolists reduces the number of firms. Since foreign control is correlated with oligopoly, industries in which foreign control is important might be expected to show less of an increase in the number of firms than other industries as

markets expand. On the other hand, to the extent that the direct investment firm has superior access to capital, technology, et cetera, than domestic firms, and insofar as there is a tendency for <u>all</u> of the leading firms in a particular industry in the United States to move into Canada, thereby making barriers to entry virtually irrelevant, it might be expected that industries that have attracted foreign direct investment would show a greater increase in the number of firms for a given expansion of the market than other industries. The examination of very unsatisfactory evidence suggests that there is no significant difference between industries in which foreign control is important, and those in which it is not, with respect to the response of the number of firms to changing industry size. A possible explanation for this tentative finding is that factors making for a high rate of entry of foreign-controlled firms in the Canadian market have been balanced by the tendency of foreign-controlled firms to engage in merger to a greater extent than domestically-controlled firms.

24. Two main points emerge from the analysis of foreign control and industrial concentration. First, many oligopolistic firms in Canada are foreign controlled and many foreign-controlled firms in

Canada are oligopolists. Second, foreign direct investment appears to have had both positive and negative effects on the degree of competitiveness of the Canadian economy. It has not clearly increased competitiveness. The first point, while widely known, has implications less widely appreciated.

25. The economic and political effects of foreign control depend on the market position of the controlling groups. Oligopoly means power - a freedom to determine goals that is not possessed by small and perfectly competitive firms. Because foreign control in Canada is substantially embodied in firms with economic power, it involves a diminution of decision-making within Canada that it would not have if it were embodied entirely in many firms actively engaged in price competition and fully subject to the discipline of the market.

26. There are a number of empirical studies on the effects of the tariff, particularly the Canadian tariff, on the structure of Canadian industry. They lend support to the preceding analysis (paragraphs 15 and 16). Much of Canadian manufacturing industry is characterized by plants of sub-optimal size and

by full-line production with short production runs and frequent change-overs, and the most important identified reason is the Canadian tariff. There is a strong case for the use of policies to rationalize Canadian industry, and for giving a high priority to tariff reduction as a policy instrument.

27. But rationalization programs might be expected to involve more than tariffs, for a variety of reasons. First, while tariff reduction creates benefits through facilitating economic efficiency, it can also create costs via effects on population size and decision-making within Canada, and this may constrain the use of the instrument, or at least its use except when accompanied by other policies to minimize these costs. When rationalization involves multi-national corporations, special care must be taken that the corporations do not centralize decision-making in a way that limits opportunities for Canadians <u>in Canada</u>. Second, while tariff reduction provides a spur for rationalization, it does not in itself provide the means. Where the merger of existing sub-optimal firms seems necessary, there is a role for government in providing leadership and planning,

as through the Department of Industry, and a potential role for an entity such as the proposed Canada Development Corporation to aid in the financing while simultaneously, via equity participation, providing a Canadian presence in those cases where the industry is largely foreign controlled. Third, rationalization reduces the number of firms in the industry and thereby risks increasing the potential for collusion. While tariff reduction reduces the risk by increasing competition from imports, it does not eliminate private restrictions on trade within Canada or at the international level. While anti-combines policy should be of a nature that does not inhibit rationalization in the public interest, it must also be of a nature that inhibits business practices that are not in the public interest within all industries, including those rationalized under government auspices.

28. This approach to "bigness" has not dealt directly with the main line of defence for oligopolistic market structures, that is, that they are dynamically more efficient than perfectly competitive structures because of the greater propensity, or capacity, of large firms to innovate. Examination of R & D spending in the United States

shows that it is, in fact, concentrated in a small number of large firms. Statistical tests on size of firm and innovational effort (measured largely by R & D spending) in the United States suggest that the latter increased more than proportionately with firm size, but only up to a point; for the largest few firms innovation does not increase and may decline. Arguments for oligopoly based on superior innovational behaviour need to be seriously qualified with respect to the giant firms. Also, it must be borne in mind that some indeterminate, but probably considerable, proportion of R & D spending is devoted to differentiation of products for marketing reasons rather than technical progress proper. Statistical analyses of variance of R & D spending by firm size in Canada indicate either no relationship, or a reverse relationship, with smaller firms having greater research intensity than larger firms. But this reverse relationship may have a paradoxical explanation, namely, that while small Canadian firms appear to be doing relatively well (compared to the United States) in terms of research intensity, large firms in Canada are too small to engage in the massive

research programs that characterize large American firms. If this explanation is correct, it lends further support to the argument made in the analysis of the effects of the tariff on the structure of Canadian industry, that is, that the large Canadian firms are too large to risk price competition but too small to be optimal in terms of efficiency - in this case dynamic efficiency in innovation. No strong and certain case can be made for a laissez faire attitude toward bigness on grounds of dynamic efficiency.

Case study

29. The structure of industry can also be analysed by studies of particular industries. There is a paucity of such studies in Canada. Case studies have been attempted of non-resident control in a small number of Canadian industries which specifically pose three interrelated questions. First, why have non-resident firms entered, or not entered, each industry? Second, what difference has the entry of non-resident firms, when it has occurred, made to performance in each industry? Third, what would appear to be the approporiate public policy for each industry?

30. In the light of the preceding analysis, an interesting case study is that for the refrigerator industry. There are nine plants producing refrigerators in Canada; with one exception, the plants appear to operate in a national market. No single producer, or group of two or three producers, currently dominates in Canadian refrigerator production. The Canadian market was in the order of 400,000 refrigerators per annum in 1966, and six of the plants appeared to be producing within the range of 40,000 to 60,000 units. Non-resident firms dominate the industry. Seven of the nine

companies involved are American controlled; they account for 80 to 85 per cent of refrigerator production, compared to 71 per cent in 1960. American direct investment in the Canadian refrigerator industry is an example of the "miniature replica effect" in the sense that it has led to the establishment of Canadian subsidiaries which almost duplicate in number the plants producing refrigerators for the much larger United States market, with the result that Canadian plants produce at much smaller scales of output. Although definitive estimates of minimum optimal scale of plants are difficult to make, it would appear that minimum optimal scale in refrigerator production is within the range of 150,000 to 200,000 units, that is, economies of large-scale production are such that unit costs fall up to perhaps 200,000 units, but not thereafter. This implies that the Canadian market is capable of supporting only two efficient refrigerator plants by present best-practice standards.

31. In fact, however, large-scale economies of production and of promotion are hopelessly intertwined. The refrigerator is a durable product that is complex and requires service, and is a

"lumpy" expenditure from the viewpoint of the consumer. These circumstances tend to make the consumer dependent on product reputation and to facilitate the rise of product differentiation as the dominant form of competition among firms. In the refrigerator industry, the principal form of product differentiation is the multiplication of models in terms of size, colour and other specifications. The multiplication of models substantially increases design and retooling costs. The lowest possible unit costs can be achieved only if the production run available to the individual refrigerator producer for each model is relatively large. The minimum optimal scale of plant is biased upwards because the multiplication of models increases the size of plant necessary to achieve economies of large-scale production for any one model. Hence, less product differentiation would presumably reduce the minimum optimal scale of plant. The pattern of inefficiency and non-price competition can persist because Canadian refrigerator production is protected by a 20 per cent tariff and Canadian producers can engage in non-price competition behind the tariff wall.

32. Foreign subsidiaries have significant advantages over domestic firms because of access to the research and designs of the parent firm and because they can take advantage of the spillover in brand name advertising from the United States. If it is assumed that the present oligopolistic competition based on the multiplication of models must be taken as given, then the dominance of foreign firms also benefits the Canadian consumer by reducing unit costs of product differentiation. In the absence of that assumption, it might be argued that foreign investment in refrigerator production - as facilitated by the Canadian tariff - has not created greater benefit to the Canadian consumer than would accrue from domestic investment and has created less benefit than would result from importation.

33. The policy implications also vary with the assumption made in this regard. On the one hand, policy-makers could elect not to take as given oligopolistic competition based on product differentiation on the grounds that the multiplication of models was wasteful of resources and manipulative of consumers. Policy would then

be directed to shifting competition from competition based on product differentiation to competition based on price. Policies could include anti-combines action designed to discourage the multiplication of product models, resale price maintenance arrangements, and the establishment of ownership links between manufacturers and retail dealers and generally to limit selling costs at the manufacturers' level; and the provision of information to consumers on the technical characteristics of products. If such policies proved effective, the result might be to reduce significantly the minimum optimum scale of plant and firm in the industry. By lowering barriers to entry, this would have the side effect of facilitating the entry of smaller Canadian-controlled firms. On the other hand, if the present form of industry competition is taken as given, an appropriate set of policies would involve rationalizing the industry so as to get fewer and larger specialized firms.

34. The key instrument would be tariff reduction. A positive role in promoting mergers could be played by the government or by the Canada Development Corporation. The use of the latter instrument would be a means by which a Canadian presence could be increased in the industry, this being unlikely to

happen under free trade itself. Equity participation in merger agreements could be regarded as a convenient strategy for increasing the degree of Canadian ownership in a way that is compatible with efficiency considerations. At the same time, anti-combines legislation should continue to apply so as to ensure that the cost-savings arising from the rationalization of production are passed on to the consumer in the form of lower prices. In conclusion, discussion of the refrigerator industry has not been for the purpose of singling out the industry but rather because its characteristics are illustrative of an important set of issues that are relevant across a broad range of Canadian secondary manufacturing industry.

Anti-combines policy

35. The moral of this analysis of the structure of Canadian industry is that policy to maintain competition should be applied vigorously - and without respect to the nationality of ownership of firms. Canada has had anti-combines legislation for many years. Its effect, however, in preventing monopolistic inefficiencies appears to have been unspectacular. It has had some effects in weakening resale price maintenance, probably only limited deterrent effects in the area of price agreement among firms, and virtually no effects in the field of mergers, price discrimination, and other monopolistic practices. It has been estimated that, up to 1960, less than 10 per cent of gross national product was produced by industries that had been investigated by the anti-combines authorities. Combines have tended to be viewed by the authorities as a police problem rather than as an economic problem. The concern has been with restrictive trade practices that could meet the test of evidence under criminal law rather than with statistical evidence of monopoly and oligopoly and economic analysis of associated deleterious effects. The law needs revision in order to

change this viewpoint. Insofar as trade and property matters are under provincial jurisdiction, the federal government should seek to strengthen anti-combines policy via federal-provincial cooperation. The revised law then needs to be applied with much greater vigour.

36. Foreign ownership enters into this policy recommendation in three respects. First, there is the extraterritorial application of American anti-trust law in Canada occurring via American ownership of Canadian firms. The intrusion of American law is not in the Canadian interest. (See below, Politics of Private Foreign Investment). Any lessening of monopoly in Canada which results is bought at the price of lessening Canadian sovereignty, and if the effects of American law are deemed economically favourable to Canada, the same effects could be achieved by more vigorous Canadian policy without the undesirable political costs. Furthermore, any tendency for American-controlled firms in Canada to be reluctant to participate in Canadian rationalization programmes because of American anti-trust law against mergers must be resisted by the Canadian authorities when such mergers are in the Canadian public interest as defined by Canadian law. Second, potential

violators of the law may be foreign-controlled firms. These firms are fully subject to Canadian anti-combines legislation, present or revised. At the same time, it must be recognized that the efficacy of Canadian policy will be increased by working in close cooperation with foreign anti-trust authorities. Third, the effect of foreign ownership on competition must be viewed in a world context. One of the motives of large corporations in undertaking foreign direct investment may be market control; the subsidiary is a means of controlling competitive threats. In a number of important industries, there is a tendency for the industry, in a world-wide basis, to come under the control of a few multi-national corporations. To some extent, collusion among independent firms from different countries is supplanted by joining the firms in corporate unity. From the viewpoint of the host country, these developments argue not only for international cooperation against oligopoly, but also for policies designed to keep alive independent domestic firms. A trend toward world dominance by a small number of large multi-national firms threatens to freeze the industrial structure at home and abroad in terms of presently established

firms. The maintenance of competition in the long-run may require the maintenance of numbers today, even to the extent of sometimes protecting domestic firms from foreign take-over so that future growing points will not be eliminated.

Conclusion

37. There is need for more Canadian policy at the national level to maintain competition within Canada and at the international level, by Canadian initiatives and cooperation with other countries, to maintain competition globally. While this means anti-monopoly policy at home and abroad, it does not preclude facilitating mergers to rationalize Canadian industry nor does it preclude a concern about foreign take-overs of established Canadian firms. The maintenance of competition, at both the national and international levels, increases the likelihood that efficient Canadian-controlled firms will survive and that the benefits of foreign investment will pass to the recipient country in lower prices and better products rather than to the parent firm in higher profits or simply be dissipated and emasculated through inefficiency.

iv. <u>Performance of Firms</u>

1. A judgment of the benefits and costs to Canada of foreign direct investment must include a careful analysis of the performance of foreign-owned firms in Canada. How does the behaviour of these firms, and their efficiency, compare with Canadian-owned firms? With their parents? With foreign subsidiaries elsewhere? What explains any similarities and differences? What are the probable consequences thereof? What are the implications for policy - with respect to both foreign-owned firms and domestic-owned firms - that follow from the findings on performance?

Availability of Information

2. The number of questions involved in an exercise of this nature is very large, and they are answerable only to the extent that information is available about the behaviour of corporations. While this may seem like a trite observation, its implications are substantial. The disclosure by corporations of their affairs and operations is of great importance to a broad spectrum of interests in society, including shareholders, creditors, prospective investors, employees, suppliers, consumers, governments and others. Informed discussion and analysis of the issues raised by the multi-national corporation depend on the quantity and quality of relevant information available to the public and the government. In spite of a decade of intense concern about these issues, and in spite of recent additions to knowledge, a substantial data gap remains to be filled.

3. The sources of information are various - though all are subject to limitations. The major sources, actual and potential, are: returns as required under the companies act where the firm

is incorporated; bankruptcy law; returns as required under securities legislation where the firm offers its shares to the public; statistics collected under the Statistics Act; tax returns filed with the Department of National Revenue; returns filed under the Corporations and Labour Unions Returns Act (CALURA); and data collected in connection with the guiding principles of "good corporate behaviour" for foreign-owned firms. In most cases, the data *per se* are not made public. Typically, they are processed by the Dominion Bureau of Statistics and issued in aggregative forms which respect the confidentiality of the data by precluding the identification of individual firms. In some cases, the data on individual firms is available to specified operating departments or agencies of the government.

4. To judge the adequacy of data, it is necessary to distinguish among its various uses. There are three distinct purposes for which information is necessary - public disclosure, economic analysis and surveillance;

to some degree, each need requires information of a distinct kind. The protection of the public, and the ability of individual members thereof to make informed decisions in their dealings with corporations, requires disclosure to the public, and not simply to shareholders, of basic financial information about individual firms. As a by-product, such information is also available to government.

5. But the information needed by government for economic analysis and for surveillance goes beyond that which is available, or can reasonably be expected to be made available, via public disclosure. For purposes of economic analysis - which, in turn, underlies the formulation of economic policy - various kinds of detailed information are required about firms. But information on individual firms can be treated confidentially and statistics made available - to the public and to government departments and agencies other than the Dominion Bureau of Statistics - only in aggregative form. For purposes of surveillance, it is necessary that relevant government officials, and not simply

D.B.S. should have access to information on individual companies.

6. The nature of corporate disclosure requirements in Canada significantly reduces the quantity of information available to the public. The most serious problem, with respect to the issue of foreign ownership and control, is the extent to which foreign-owned firms are relieved of the necessity of public disclosure by virtue of their status as private companies. Companies may incorporate under either federal or provincial jurisdiction, and may be either public or private companies. Federally-incorporated public companies - but <u>not</u> private companies - have to file an audited financial statement with the Registrar-General, but it would appear that, as a matter of administrative practice, these returns are not made available to the general public. Of the provinces, only three require any filing.

7. Under the present Canada Corporations Act, companies with fewer than fifty shareholders which do not offer securities to

the public and which become subject to restrictions on transferability of shares, are private companies; requirements under provincial legislation are generally similar. As such, there is no mechanism by which financial disclosure to the public takes place. Since a parent company is regarded as one shareholder, subsidiaries wholly-owned by a parent company are entitled to the status of a private company. The latter status was presumably intended to permit an individual or a family to have the benefits of corporate status, though not the right to issue shares publicly, without the costs of disclosure imposed on public companies; its beneficiaries might be expected to be primarily relatively small firms. In fact, corporations have successfully used such legislation to obtain for themselves with respect to their wholly-owned subsidiaries these rights of privacy intended for individuals and families. Hence, wholly-owned subsidiaries of foreign corporations can avoid disclosure in spite of the fact that their parents are typically public companies in the foreign jurisdiction, and in spite of the

fact that they may be large and important firms dominating important industries. Canadian-owned firms can also avail themselves of this anomalous situation, that is, the law per se does not discriminate in favour of foreign firms, but in fact the great majority of the large private companies in Canada are foreign-owned.

8. In the nature of the case, that is, the failure of private companies regardless of size to disclose, it is impossible to determine precisely even the number of large private companies in Canada. On the basis of data on 743 of the largest Canadian companies (the criteria for selection are discussed below), it appears that 60 per cent are private companies. A number of these private companies, however, are wholly-owned subsidiaries of public companies so that their financial statements are part of published consolidated statements. If one looks at corporate complexes - parent company plus wholly-owned subsidiaries, and Canadian companies each wholly-owned by the same non-resident parent company - of 375 of the largest non-financial Canadian corporate complexes that could be identified in terms both of existence and

ownership, 162 or 43 per cent are private companies, and about 75 per cent of those private companies are controlled by non-residents. 169 of the largest private company complexes have over $11 billion in assets (at book values) or about 12 per cent of the total for all Canadian corporations, accounting for about 12 per cent of corporation sales, and accounting for 19 per cent of corporation taxable income.

9. The list of non-disclosing foreign-owned private companies included such well-known and important firms as British Petroleum, Canadian International Paper, Canadian Kodak, Chrysler, Coca Cola, General Foods, General Motors, Household Finance, I.B.M., Kraft Foods, Proctor and Gamble and Sun Oil. (The best-known of the non-disclosing Canadian-owned private companies are Eaton's and the Irving interests.) Such companies do not have to publish financial accounts of any kind in Canada, the financial operations of the subsidiaries of foreign companies being consolidated with those of their parents, so the Canadian public has no access to information on their Canadian operations. The absence of published financial statements

similarly blocks an important means by which government officials might get a minimal amount of information.

10. The blame for this state of affairs must properly be put at the door of Canadian governments for not insisting on public disclosure. It can hardly be doubted that foreign firms would disclose were they legally required to do so. At the same time, realism requires recognition that companies find disclosure at least an inconvenience and that they are not adverse to using their influence to limit its extent.

11. One solution lies along the lines of amending the Canada Corporations Act to require more disclosure, particularly by large private companies without respect to the nationality of their ownership, and altering administrative practice so that returns filed with the Registrar-General are, with certainty, available to the general public. This is necessarily an inadequate solution to obtaining general disclosure, however, insofar as it would apply only to federally incorporated companies and would presumably

discourage use of the Canada Corporations Act in favour of provincial companies acts, the latter requiring little, if any, public disclosure of corporate financial information. The use of company law as a way to get more information on firms, then, is limited in the absence of federal-provincial cooperation. The latter should be sought, but so should alternative means of making information available, both to the public and to government officials.

12. A potential means which might be relied upon to support a federal disclosure statute applicable to all corporations carrying on business in Canada, including provincial corporations, is the federal bankruptcy power. Indeed, this would appear to be the great untapped reservoir of constitutional power to support a federal disclosure statute. Requiring disclosure at moderately short intervals would enable creditors to detect when a business is "going sour". But can the possibility of the economic dissolution of a few firms justify a requirement placed on all firms? While the courts would have to rule as to whether a disclosure requirement can properly be treated as ancillary

to bankruptcy law, the question does permit an affirmative answer. It might be argued that a statute clearly designed as a means of averting or warning of impending bankruptcy should be directed only to firms which might conceivably be subject to this state. However, if one knew which firms were on the verge of economic collapse, there would be no need for such a disclosure statute at all. It is this very uncertainty that necessitates casting the disclosure net so widely. Because it cannot be known which firms will collapse, all firms must be subjected to the same requirement. Also, if the statute included a penalty provision which imposes liability on the directors of a company which has failed to disclose statutorily required information when the company is subsequently unable to meet its debts, as is the case in the United States, there would be even greater reason for treating the provision as bankruptcy legislation.

13. Since the private company does not issue shares to members of the public, its prevalence in Canada significantly reduces the quantity of information available through securities legislation.

This is a serious matter since securities legislation is an efficient means - in the United States, for example, more efficient than company law - to get public disclosures of financial information. Securities legislation is relevant, however, only if companies have publicly-traded issues of shares. The policy inference is that there will be benefits from disclosure to the extent that companies issue shares to the public and thereby become subject to securities legislation. In the process, previously private companies will also have to meet any disclosure requirements of company law, and the two effects will be additive. (In principle, disclosure should be gotten from private companies under company law without issue of shares to the public, that is, there could be "disclosing private companies".) For constitutional reasons, the use of securities legislation at the federal level appears to depend on federal-provincial cooperation.

14. Under the Statistics Act, the Dominion Bureau of Statistics collects masses of information. Most of this information is collected on a confidential basis, and when issued outside the Bureau, to the public or to government departments and agencies,

is grouped so that the operations of particular firms are not revealed. If this were not done, it might prove impossible to secure the cooperation of firms in supplying correct figures on a wide variety of topics which form the heart of the Canadian statistical system. For the purposes of economic analysis, inside and outside the government, these figures are invaluable, and their supply should not be jeopardized.

15. The data now available from the Bureau on Canada's international investment position are extensive and invaluable. For several decades, detailed records have been kept of the investment in direct investment companies, and in recent years the scope of the detail made public has been considerably extended. These data on Canada's international investment position are probably unequalled anywhere in scope and quality, and this has been done, moreover, with a minimum of professional resources. If more professional resources were made available, however, there are deficiencies which could be overcome.

16. Published information on Canada's international investment position could be made available with a shorter time lag. Data on

foreign long-term investment by major industrial groups needs to be disaggregated beyond the present eleven industries and a large heterogeneous miscellaneous group. Data on foreign-owned firms needs to be integrated with data on all firms that are also available from the Bureau, so that comparisons can be more readily made that will permit the isolation of nationality of ownership as an independent variable. Special aspects of direct investment, such as minority ownership and joint ventures, need more systematic study. More detailed analysis is needed of foreign take-overs - and reverse take-overs - since their implications are not necessarily the same as for new direct investment. Further studies should be made of the extent of foreign ownership and control in sectors not now covered or inadequately covered, such as agriculture and finance, so that there will be a better understanding of the place of foreign capital throughout the whole economy.

17. All Canadian corporations, including private corporations both resident and foreign-owned, have to file tax returns with the Department of National Revenue. Information collected thereby is an incidental by-product to the main purpose of tax

returns, which is to ensure the collection of tax revenue. So important is the latter that it would be unwise to risk jeopardizing the tax base by disclosing individual returns either to the public or to other government departments. At the same time, statistics can be compiled from the tax returns and issued in aggregative forms that preclude the identification of individual companies; this is presently done to some extent by the Dominion Bureau of Statistics and is useful for purposes of economic analysis.

18. Canadian corporations, private and public, whose gross revenues exceed $500,000 or whose assets exceed $250,000 (excluding certain financial institutions, utilities and some other firms) are required, since 1962, to file returns under the Corporations and Labour Unions Returns Act. The intent was to provide certain information on individual companies to both the public and government officials and to collect data which, in aggregative form, could be used for economic analysis. Insofar as information was available on specific oompanies, including private as well as public companies, the purposes of public disclosure and surveillance could be served;

indeed, CALURA was developed in response to a widely-felt need for more information on private companies in particular. Actual achievements have proven to be modest. The information on particular firms made available to the public has been limited to data on incorporation, officers and directors, and on the ownership of the corporation's issued share capital. The financial statements of the corporation, and a schedule of payments abroad of income and certain business services, were not made available to the public. The public disclosure function was, on the whole, not served effectively. The latter information was made available to other government departments, thereby permitting CALURA to meet the surveillance purpose, but only initially. A subsequent amendment to the Act had the effect of blocking access to the latter information to other government departments as well. The surveillance function was thereby largely eliminated.

19. The usefulness of CALURA is now mostly for economic analysis, and even in this respect there is room for improvement. The data collected are largely items which appear directly on the firms' financial statements; there is considerable room for widening the scope of the questions put so as

to gain information on economic performance. Integration of financial information under CALURA with taxation statistics and other D.B.S. data has begun, but could go much further and would permit classification by nationality of ownership of a great array of available material not now possible. Recognition of the inherent difficulties of meeting the purposes of public disclosure suggests that greater use should be made of CALURA. Financial statements and schedules not now made available to the public should be made available by amending CALURA. They would thereby automatically become available to government departments and agencies, restoring the surveillance function to CALURA to that extent. CALURA is unique in its apparent potential to fill all three purposes for which it is needed.

20. When the Government of Canada issued guiding principles of "good corporate behaviour" to foreign-owned firms operating in Canada early in 1966, questionnaires were sent out to foreign-owned firms with assets in excess of $5 million. The guidelines questionnaires provided, in some

cases for the first time officially in Canada, data on the exports, imports, research expenditure, and income and service payments abroad by foreign-owned firms; data were also collected on selected quarterly capital transactions, partly in order to ascertain what the effects of the American and Canadian guidelines have been on the international operations of these companies. The guiding principles as such are discussed below; concern at this point is with the quality of the data collected and the value of the published analysis thereof. These statistics are important, since they have the potential to cast definitive light on the performance of foreign-owned firms, and thereby to provide a solid body of knowledge for the surveillance of foreign-owned firms; improvements in collection and analysis are therefore important. Since this is a new source of information, some improvements can reasonably be expected to take place with time.

21. On the basis of the brief experience to date, a number of improvements already appear to be in order. First, the returns are voluntary, and should be compulsory. While there has been

substantial compliance, considerable resources have had to be devoted to follow-up efforts. Since the purpose of the questionnaire is to meet the surveillance function as well as the analysis function, mandatory compliance is necessary. Should this be deemed to constitute discrimination against foreign-owned firms, then the questionnaire might be confined to the larger firms and sent to all firms. Second, the data being collected do not go as far as they might in rendering the guiding principles operational. A case in point is the export policy of subsidiaries. The guiding principles call for "maximum development of market opportunities in other countries as well as in Canada"; indeed, the government has long had an export promotion program in which foreign-owned subsidiaries have been expected to participate fully. It is known, however, that in some multi-national firms there are private arrangements within the firm which limit or proscribe exports by subsidiaries. What is not known, but could be determined, is how widespread such arrangements are, which markets and products are affected, what methods of restriction are used, to what extent - given comparative costs of production - exports are actually being impeded,

and so on. Third, the nature of the data as presently collected does not permit a sufficiently accurate judgment of the effect on the Canadian balance of payments of the operations of the larger foreign-owned firms, though this is clearly an issue of the first importance. Fourth, the data being collected on foreign-owned firms do not have as their counterpart equivalent data on Canadian-owned firms, though comparisons of performance are necessary if the foreign-owned firm is to be judged fairly.

22. A number of these difficulties could be eliminated if a distinction were to be drawn between the two functions of economic analysis and surveillance. For the former purpose, aggregate statistics issued by D.B.S., though including comparisons with resident-owned firms, are sufficient. The collection of the necessary data could be done under CALURA (amended) and by other means, could be left to D.B.S. and confidentiality respected. The guiding principles questionnaire could be designed to meet only the surveillance function. A compulsory questionnaire would be drawn up to be sent to the larger foreign-owned firms by the Department of Trade and Commerce,

or some other operating department or agency, requesting data on issues relevant to making the guiding principles operational. Relevant government officials would have access to returns from individual companies.

23. Information for purposes of public disclosure is grossly inadequate and the federal government should leave no stone unturned to rectify this situation. Information for purposes of economic analysis is generally very good, but improvements are possible in some particulars. Information for purposes of surveillance requires information on individual firms being available to relevant operating departments and agencies, and is presently inadequate with respect to both quantity and quality.

24. In spite of these deficiencies, it is possible to say a good deal about the performance of foreign-owned firms, partly on the basis of private studies based on interviews and questionnaires, and partly by inferences from data on industrial concentration, case studies of industries, and other sources. Relevant insights about the performance of foreign-owned firms on the basis of productivity and price

trends have already been presented above.

(see Sources of Economic Growth.)

Performance of Foreign-Owned Firms

25. Direct investment conveys both benefits and costs to the host country. An aspect of the costs which has received increasing attention in Canada is the economic performance and efficiency of the foreign-owned firms. The criticism is made that decisions about Canadian-based facilities, taken in the context of the multi-national firm, may lead to something less than the maximum efficient development of Canadian resources, and may also tend to bias the development of the economy against secondary manufactures and certain kinds of expenditures, such as those for research and development. Conflicts of interest between subsidiary and parent are assumed to arise because decisions which may appear reasonable and profitable from the point of view of the multi-national firm as a whole may not lead to the maximum efficient development of the subsidiary. Moreover, the centralization of some key decisions in the multi-national firm may work against the interests of the subsidiary and the national economy in which it is located because head office personnel are uninformed about, or insufficiently interested in, the potential for the subsidiary while retaining

power over decisions affecting it.

26. Governments of the investing countries can and do use the multi-national firm as a medium for influencing corporate activity so as to further their economic and political objectives, and thereby affect the performance and efficiency of subsidiaries. Serious problems have been created for Canada, as in the case of the extraterritorial application of United States law, which are discussed elsewhere. This section is limited to the logic and results of economic performance within the multi-national corporation qua multi-national corporation. The approach used is a dual one. The facts regarding the operations of subsidiary firms in Canada, to the extent they are known, are summarized. But these alone indicate nothing about feasible, or desirable, performance. Comparisons are therefore made, wherever possible, with resident-owned firms, parent companies, direct investment companies in other countries, and between subsidiaries with varying degrees of foreign ownership.

27. One of the important resources for any country is the managerial resource. Do foreign-owned firms discriminate against the employment of Canadians in their senior positions, thereby

limiting the opportunities for and development of such persons? It is known that Canadians are represented in the senior positions of most of these companies, particularly the larger ones, but that this is not true of a significant minority. In 1962, data available for the 138 corporations in manufacturing, mining, and petroleum with assets of $25 million or more and 50 per cent of whose voting stock was owned abroad, show that the president was resident in Canada in 103 of these foreign-owned corporations, but in only 62, or less than half of the firms, was he a Canadian citizen. Furthermore, the chairman of the board of the Canadian company was typically a national of the country of the parent firm. Of the 865 other officers resident in Canada, 706 were Canadian citizens. A study of 280 subsidiaries, both large and small, showed that in about one-fifth of the firms the next three senior officers after the president were all citizens of foreign countries. It also showed that there was a marked increase in the percentage of presidents who were Canadian citizens, as the size of the firm increased, and a somewhat less marked increase as the age of the firm increased. There is a tendency,

particularly among smaller and newer firms, to have a disproportionate number of persons from the parent in senior positions. This may be necessary in some cases in the early phases of introduction of new technology and products, but not all firms see even that necessity. Another, and serious, problem is the non-representation of French-speaking Canadians in the senior positions of foreign-owned firms in Quebec, a practice in which these firms parallel their Canadian-owned counterparts from other provinces.

28. Do foreign-owned firms have disproportionate representation by foreigners on their boards of directors, thereby reducing the likelihood of a Canadian point of view being represented? The study just cited of 280 subsidiaries showed that about one-quarter had inactive boards, which can be taken as the limiting case of non-Canadian representation by this means. Among the remainder, the 1,505 directors included 634 who were associated with the parent or its other foreign affiliates, 565 who were drawn from senior management of the Canadian company, 211 other residents not otherwise associated with either

company, and 85 representing other significant owners, legal counsel, and so on. About one-half of the directors resided in Canada. Only 10 boards were without a single resident. In 33 boards, resident directors formed less than 25 per cent of the membership.

29. For these subsidiary firms, the percentage of presidents who were Canadians, and the extent to which directors resided in Canada, both tended to rise as foreign ownership fell. In sharp contrast with the subsidiaries, all but a few of the senior personnel and boards for Canadian-owned companies were Canadian citizens and residents. Compared to Canada, it appears that Americans are less fully represented in the senior management of United States-owned firms in the United Kingdom and Australia, probably because of greater distance and lower salary scales.

30. The composition of the management and boards of subsidiaries is one thing, the latitude allowed them in decision-making something else. The latter is important because decentralization of decision-making

both helps to assure that the interests of the subsidiary are fully considered and facilitates management development at the local level through "learning by doing". The direct investment firm is, by definition, one in which the voting stock is controlled by non-residents. Furthermore, in the nature of the case, there is a good deal of contact between officers and technical personnel of the parent and its subsidiary, not only through representation of the parent's officers on the Canadian board, but at other levels. Within this context, what degree of centralization of decision-making is involved at the actual operational and policy levels? Existing studies indicate a wide variation in the discretion allowed the managers of subsidiaries, except on certain key issues where discretion is slight or nil.

31. A recent study of Canadian experience suggested that in 20 per cent of the subsidiaries there was very substantial decentralization of decision-making with respect to both operations and policies, with the parent's direct influence largely felt through its representation on the Canadian board. In another 20 per cent, policy determination was highly centralized with varying

degrees of operational freedom. The remaining 60 per cent represented cases where there was a high degree of operational decentralization, and with the officers of the subsidiary playing a role in policy determination, particularly in initiating changes, though final authority lay elsewhere. Where major policy changes were involved, however, the officers of the parent company had to be consulted. Looked at another way, in virtually all cases the parent's officers had to be consulted on major policy changes, especially if significant financial changes were involved, and they appointed the senior executive of the subsidiary. The degree of decentralization tended to be greater for production planning, marketing, and labour relations - though some problems have since arisen with respect to the latter (see below) - less on introduction of new products and techniques and still less on major policy involving financial changes affecting the owner's interest.

32. Centralization is presumably dictated by the need of the officers of the parent corporation to review the consistency of local decisions relative to the objectives of, and conflicts of

interest within, the multi-national firm. It is aided by standardized accounting procedures and improved communications. Decentralization is necessary because of differences in the settings of the various subsidiaries, and in order to attract and retain competent managers in the subsidiary. Decentralization tends to be greater where the firm is older, in a joint venture, or in a profitable operation, and to be less where the Canadian subsidiary is the only foreign subsidiary. It also tends to be less where a few products identical to those of the parent are produced in an integrated operation. The latter point is important because of its implications for tariff policy. Free trade would encourage multi-national firms to rationalize and integrate their operations and, therefore, could be expected to decrease decentralization in those cases where the production process permits such integration, and except to the extent that increased size confers more autonomy. The apparent extent of autonomy of Canadian subsidiaries is explained, in part, by the existence of Canadian and foreign tariffs.

33. The Canadian interest is best served by ensuring that the maximum number of residents, and particularly of Canadian citizens, be appointed to the senior positions of management and to active Canadian boards, and that there is the maximum possible degree of decentralization of decision-making to the subsidiary. These will mean that competent Canadians can make their careers and contributions in Canada and that the interests of the Canadian subsidiary are given full consideration within the multi-national firm. There are limits to this process, however, both in terms of the other objectives of Canadian policy and in terms of the nature of the multi-national firm. Canada is not rich in entrepreneurial and managerial talent, at least relative to the United States, and bars to the import of that talent, whether legal or informal, are not desirable. Moreover, an important aspect of the efficient functioning and growth of the subsidiary is the transfer of management and related techniques from the parent to the subsidiary. In this context, the appropriate question is whether local managers have freedom of choice and are permitted to exercise initiative or are told what to do and are restricted in terms of

markets, products, or techniques. Finally, while considerable variation in the loci of decision-making is possible within the multi-national firm, there are limits to decentralization. The owners of capital demand some minimum accounting about the use of their assets abroad, and this necessarily limits decentralization on the financing of the subsidiary in particular and major policy decisions in general.

34. The multi-national firm and foreign trade are intimately linked. This is obvious in the case of raw material exports by subsidiaries, but is also significant for import replacement by subsidiaries. Foreign direct investment leads to significant continuing inter-company transactions across national borders, as well as trade with independent firms abroad. A concern expressed by Canadians in this connection is whether the existence of foreign affiliates prevents export from Canada to the markets of these affiliates, while the Canadian subsidiary is required to purchase from the parent rather than locally in order to enhance the latter's sales. These phenomena would tend to lessen the expansion of the Canadian manufacturing

sector and create trade deficits for Canada.

35. Assuming that a firm maximizes its profits internationally, it should locate its production facilities, including those for export, in the most efficient locations, whether these are in the parent company market or in the subsidiary's market. It would be inconsistent with global profit maximization for a multi-national firm to favour a particular less efficient location; the profits, after all, accrue to the parent. (The same behaviour would be expected of a resident-owned firm with facilities abroad). But exceptions are possible. In the short-run, while existing assets have not been written off, the firm may protect these from inroads by affiliated firms as well as non-affiliates, especially if there is excess capacity in that part of its operations. Such protection of higher-cost facilities runs both ways, however; if the Canadian facilities were higher cost, they would enjoy the private protection. This protection is temporary, however; over time, the firm writes off assets, requires new facilities as demand expands or is forced by competitors to locate efficiently. Competition may be

restricted by agreements among multi-national firms, involving restrictions of markets to which firms may ship, abuse of industrial property rights, and so on. These agreements or abuses can be extended to cover operations of subsidiaries, thus effectively blocking their foreign trade. In this case, the firm maximizes global profits but does not locate its production efficiently in terms of comparative costs. Furthermore, the nationality of performance may affect decisions, profit-maximization notwithstanding. Multi-national firms, relative to purely domestic corporations may maximize within different space horizons and be subject to a different set of policy constraints. Directors and officers may be biased towards their home country and the directives of its government.

36. The available data indicate that the direct investment firm has created substantial exports and substantial import replacement. But some evidence points to export restriction in a significant minority of cases, a phenomenon which could become bothersome as legal barriers to trade decline and as Canadian manufacturing

production becomes more efficient and export-oriented, while on the import side, there is some evidence that foreign-owned firms are more import-oriented than Canadian-owned firms. With respect to exports of subsidiaries, the only complete count made for Canada is for 1957, showing that United States-controlled firms in Canadian mining and petroleum and in manufacturing, respectively, accounted for a larger share of exports than of ownership in each case. More recent data, based on a large sample of firms in Canadian manufacturing, show that in 1965 American-owned firms accounted for 48 per cent of exports of manufactures from Canada at a time when residents of the United States owned 44 per cent and controlled 46 per cent of the capital invested in Canadian manufacturing. American subsidiaries in some other countries are more oriented to exports than in Canada. In the United Kingdom, they accounted for 17 per cent of all exports of manufactures, while accounting for 7.5 per cent of the capital and 10 per cent of the sales

in British manufacturing industries. There are, indeed, striking variations in the exports of United States subsidiaries abroad, reflecting the different locales in which they are situated. In 1965, American-owned subsidiaries and branches in Canadian manufacturing sold abroad almost 20 per cent of their sales, compared with 35 per cent for the Benelux countries, 27 per cent for Germany, 25 per cent for the United Kingdom, 17 per cent for France, 14 per cent for Italy and 8 per cent for Japan. Examination of the composition of these exports indicates high concentration by products. Comparing American-owned firms in Canada with American-owned firms elsewhere, Canadian exports as a percentage of sales are greatly in excess of those for other regions and countries in the case of paper and allied products, and primary and fabricated metals. For most manufactured products, however, the Canadian export percentage from direct investment firms is below that of Europe while in excess of that for other areas. The discrepancy with Europe is large in non-electrical machinery, transportation equipment, rubber products and

chemicals. These data suggest that American direct investment *per se* is not a bar to export of manufactures if production costs, the associated research base, and related circumstances warrant, for such firms in Europe exported between 16 per cent and 32 per cent of their sales of these four product groups in 1965. Finally, sales of American mining subsidiaries in foreign countries are at least 70 per cent for export in each of Canada, Latin America, Europe, and other areas. While comparable data are not available on petroleum exports, they are known to be substantial.

37. While no comprehensive data are available on imports into Canada by direct investment firms, information based on a large sample of manufacturing firms shows that in 1963 American-owned subsidiaries and branches imported $1.7 billion into Canada, with almost $600 million being accounted for by the transportation equipment industry (largely automobiles and parts), almost $300 million by the machinery industry, $200 million by electrical machinery industries, and $250 million by chemical industries. Overall, and for most of the

industrial categories, such imports as a percentage of sales of the subsidiary were higher for Canada than for other areas in which American affiliates were located, although part of this difference may reflect problems of measurement.

38. Data for 266 of the larger foreign-owned companies in 1964 and 1965, compiled from the guiding principles questionnaire, indicate that these firms accounted for about one-third of both Canadian exports and imports. In 1965, 63 per cent of their exports went to the United States and 77 per cent of the imports were from the United States. About 50 per cent of all foreign sales were to affiliates and about 70 per cent of all foreign purchases were from affiliates. Their trade with the United States yielded a deficit of $345 million, and $500 million with foreign affiliates, which in each case was just offset by trade with other countries and non-affiliates, respectively. The natural resource-oriented industries accounted for $1.85 billion of exports in 1965, being

about two-thirds of all foreign sales by reporting companies. Imports by these resource-oriented firms were $655 million, leaving a trade surplus of about $1.2 billion. Other industries, however, accounted for imports of $2 billion and exports of $900 million, leaving a trade deficit of about $1.1 billion. Bearing in mind the limitations of these data, they show not only substantial deficits with the United States and with affiliates which are at least offset by trade with other countries and with non-affiliates, but also a substantial deficit on secondary manufactures which is at least offset by a substantial surplus in primary products and primary manufactures. Since these firms have a deficit on interest, dividend and business service account, their direct effect on the current account balance would appear to be negative (see below, Balance of Payments).

39. A study of 280 firms, which concentrated on the number of firms falling in export or import categories rather than the overall value of exports or imports, showed that there was a

substantial increase in exports as a percentage of sales as the size of firm grew, that firms with products identical to those of their parents exported a smaller share of output than those whose products were modified, and that as the subsidiary's product range narrowed relative to its parent it tended to export more. On the import side, the percentage of purchases from Canadian suppliers tended to be higher the larger the firm. Little relationship existed between age of firm and domestic content of purchases. Those producing only a few of their parents' products had a higher domestic content than those producing a wider range thereof.

40. Tests indicate that affiliation *per se* does affect foreign trade somewhat, though not to the extent that is sometimes alleged. There does not appear to be a tendency for firms to export less as the number of their affiliates abroad increases; indeed, the tendency is the opposite. If firms are grouped by degree of foreign ownership - that is, wholly-owned, 75 per cent or more foreign-owned, less than 75 per cent foreign-owned - there is no statistically significant difference in exports or imports among

these groups. A study of 160 non-resident owned firms and 96 resident-owned firms - which restricted itself to firms with assets of $1 million or more, achieved some broad comparability of industrial sub-groups, and tested sub-groups such as those with assets of $25 million or more, those producing fully processed and manufactured goods only, and those in comparable age groups - found that the performance of the two sets of firms was similar with respect to exports, but that the foreign-owned firm was somewhat more import-oriented, or somewhat less inclined to source locally, than the Canadian-owned firm. (This does not mean that the foreign-owned firm has not substituted local production for imports on a large scale; the data shows that it has). The greater import-orientation of the subsidiaries presumably reflects, in part, the greater opportunity for specialization in supply with respect to the parent.

41. Detailed study of the practices of firms indicates both positive and negative effects of affiliation on exports. The study of 280 firms showed that in many cases there was no effect

on exports because transfer costs were prohibitive. In a significant number of cases the effects were favourable; for example, the parent bought some of the output of the subsidiary on a guaranteed basis, or access to the research, export sales organization or customers of the parent aided export sales by the subsidiary. In a significant minority of cases, the effect of affiliation was actually or potentially negative in terms of exports by the subsidiary. Sometimes this reflected a situation in the parent's export sales organization which did not permit competitive bidding for export orders by the subsidiary, or the direct solicitation of export business. Frequently, it reflected the fact that patent rights assigned to the subsidiary did not cover all (or any) foreign markets because of the existence of other licensees abroad with exclusive rights to certain markets or other restrictive agreements. In these cases, however, the subsidiary often had an exclusive right to the Canadian market under the patent, and was thus protected from import competition. About 15 per cent of the firms appeared to be subject to private trade restrictions of these and similar types. The restrictions were highly

concentrated in machinery industries, electrical products, and some branches of chemical industries. But most of these restrictions appeared to be potential rather than actual, since the firms involved typically reported unit production costs exceeding those of their affiliates. Studies by the Australian government of the export franchises of all firms which are foreign-owned and also of those with overseas licensing agreements show that about 15 per cent of the firms had no export franchise or one that was limited. Limitations on exports of subsidiaries notwithstanding, these firms are likely to have a wider export franchise than independent firms with a licensing agreement. (For a further discussion of licensing arrangements, see below. Export restrictions arising from American law on trade with Communist countries are discussed under Politics of Private Foreign Investment.) In general, these findings bear out the view that international oligopoly is important.

42. Study of the import practices of subsidiaries also indicate positive and negative effects from the point of view of efficient national development. Joint purchases with affiliates and special contacts

with suppliers lower costs significantly in some cases. Tied purchases, however, militate against the development of efficient local sources of supply. It would appear that such explicit restrictions are much more limited on the import side than the export side, and that the high imports of manufacturing subsidiaries reflect in the main the similarity of products of the two groups of firms.

43. Direct investment brings a variety of techniques to the recipient country, including management skills, labour training, the results of research and development, production "know-how" and other information. The concern expressed in Canada in these respects is that the ease of access to such techniques from the parent may cause the subsidiary to neglect the development of these skills within Canada. The paucity of data limits consideration to one aspect only of these transfers of techniques, research and development. As was seen above (see <u>Sources of Economic Growth</u>), Canada does not rank highly in R & D spending relative to other advanced industrial countries, and is

specifically lower than the United States and the United Kingdom. Nevertheless, comparisons of the research performance of foreign-owned and Canadian-owned firms suggest that the former do relatively more research than the latter, even when allowance is made for the tendency of foreign firms to be concentrated in research-oriented industries. By broad industry groupings, there is clear evidence of a positive relationship between research as a percentage of sales and the degree of foreign ownership. In 1963, dollars spent for R & D in Canada per hundred dollars of sales averaged 0.84 for industry as a whole. Six industry groups exceeded this figure: electrical products, with R & D spending of 3.18 per hundred dollars of sales and a foreign control ratio of 77 per cent; chemicals and products, where the corresponding figures were 2.22 and 78 per cent; rubber, 1.18 and 97 per cent; mining and oil wells, 1.11 and 51 to 62 per cent (depending on the sector); and transportation equipment, 0.93 average for the various industries involved and 78 to 97 per cent, depending on the sector. Industries which spent less than 0.84 dollars for R & D in Canada per hundred dollars of sales typically had a minority

of their capital owned by non-residents. Three industries whose capital is largely owned by foreigners - transportation equipment, electrical products, and chemicals and chemical products - accounted for 55 per cent of R & D in 1963. While the first two industries received large sums from government for R & D, they also spent more of their own funds thereon than any major industry group except chemicals.

44. But these data may mean only that foreign-owned firms tend to be in research-oriented industries. A detailed study for 1959 of a sample of foreign-owned and Canadian-owned firms casts light on this and related issues. Almost half of the subsidiaries were doing research in Canada. The subsidiary was more likely to be doing research if its products were differentiated from those of its parent. Most of the subsidiaries were spending less on research, relative to sales, than were their parents, and their programs had a smaller fundamental research component, if any. Among those subsidiaries which were the largest spenders on research in Canada as a percentage of sales, the proportion rating access to the parent's research as very important was moderately in excess of those with smaller Canadian research programs; substantial continued access to the research of the parent was apparently not a bar to the development

of significant research programs in the subsidiary. There was no consistent relationship between research as a percentage of sales and the degree to which the foreign parent held the stock of the Canadian subsidiary A comparison of the research performance of resident-owned and non-resident-owned firms with assets of $1 million or more in broadly comparable industrial groups suggested that there was not a statistically significant difference in performance of research as a per cent of sales; that the degree of sophistication in the research programs of the two sets of firms was not markedly different; and that very few of either group of firms was doing any fundamental research. On the basis of Canadian data for 1963 and United States data for 1964, a statistical test relating R & D intensity (R & D as a percentage of output) to degree of foreign control and corresponding research intensity in the same industry in the United States shows that research intensity in Canada depends positively on foreign ownership and on research intensity in the same industry in the United States.

45. The evidence, then, is that subsidiaries perform either as well as or better than Canadian-owned firms in terms of R & D. They do not, however, perform as well as their parents. While conventional Canadian

concerns find little support from this analysis, neither is the case made previously (see Sources of Economic Growth) that there is deficiency in R & D spending in Canada refuted. Given that foreign-owned firms in Canada have access to many of the most outstanding industrial laboratories in the world, which spend on research many times all of the industrial research undertaken in Canada, it is difficult to believe that Canadians have either taken maximum advantage of this access or supplemented it in an optimal way.

46. A dimension of the performance of foreign-owned firms that has recently attracted widespread attention and concern in Canada is a tendency in some cases for labour negotiations for the Canadian subsidiary to be conducted in the United States by the parent firm. Insofar as this leads to important decisions for Canada being made outside Canada, with a consequent risk that Canadian circumstances will be neglected and bargains struck that are not in the Canadian interest, foreign ownership *per se* has adverse effects relative to Canadian ownership. At the same time, while foreign ownership is a necessary condition for this to happen, it is not a sufficient condition. The ability of the American parent to negotiate for the subsidiary also requires that the Canadian workers

be affiliated with the relevant American trade union, and that the former be willing to let the latter conduct its negotiations with management. Furthermore, to the extent that Canadian concern is about the nature of the wage settlements negotiated - specifically, "wage parity" with American workers, putting pressure on Canadian wage levels and labour costs - rather than where the negotiations take place, such settlements can take place in the absence of American ownership - and even in the absence of Canadian labour affiliations with American unions - where the bargaining strength and productivity of Canadian labour permit. Also, wage parity settlements in the automobile industry negotiated in Detroit are, in part, a side effect of the Canadian program to rationalize that industry on a North American basis. To the extent that rationalization increases labour productivity, wages may be expected to rise in Canada, while it should be expected that American union leaders may further encourage rising wage levels in Canada to protect an outward shift of jobs from the United States. The relevant moral is that rationalization programs should focus centrally on lowering prices to Canadian consumers, thereby reducing the ability of labour and management to reap the full benefits of rationalization and diffusing these benefits widely. In sum, however,

foreign ownership must be judged to facilitate some labour practices that may not be in the Canadian interest, and to that extent the performance of subsidiaries is unsatisfactory relative to their Canadian counterparts.

47. There has been considerable criticism in Canada of the practice of most of the subsidiaries in reserving their entire voting stock for the parent. It is clear that the multi-national firm has strong preferences in this respect. It has already been noted that for 375 of the largest non-financial Canadian corporate complexes, 162 or 43 per cent are private companies with no publicly traded shares, and about 75 per cent of these private companies are controlled by non-residents. Data compiled under CALURA show that in 1963 there were 1,961 corporations in manufacturing and mining whose stock was at least 50 per cent held outside Canada. In 72 per cent of these firms, 95 per cent or more of the voting stock was held outside Canada, that is, typically 100 per cent of the stock was held by the parent except for directors' qualifying shares. In 13 per cent of the firms, between 75 and 94.9 per cent of the stock was held by non-residents. The corresponding proportions for the service and financial industries covered by

CALURA were 70 per cent, 12 per cent, and 18 per cent, respectively. It appears that larger subsidiaries have issued a larger share of their equity to Canadians. At the end of 1960, 19 per cent of the equity was held by Canadians in the case of foreign-controlled firms with assets of $25 million or more, compared with 9 per cent for smaller firms. Also, the preference for the wholly-owned subsidiary appears to be stronger in secondary manufacturing than in primary industries and primary manufacturing. The preference by American parent companies for full ownership of the subsidiaries' voting stock is not simply a Canadian phenomenon. It is estimated that in 1957 nearly three-quarters of United States direct investment abroad was in enterprises (including foreign unincorporated branches of American corporations) in which the United States share of equity was at least 95 per cent. In no major geographic area or country was the non-American ownership of the firms much in excess of one-quarter of the total.

48. Why do so many subsidiaries persist in refusing to issue shares in spite of the clearly stated preference for this on the part of the government of Canada and the various tax incentives which have been introduced to encourage this? There are a number of reasons. Share issue requires some disclosure of

financial information; this is, at the least, an inconvenience. The foreign owners are unwilling to share the profits of the firms they have developed, including those that accrue from monopoly or oligopoly positions. There are technical problems in the timing and pricing of share issues, and a public share issue is not appropriate to all types and sizes of firms. But the selling of shares is also avoided because it diminishes flexibility within the multi-national enterprise. Decisions about location of plant and production, financing of activity, exchange of information, and pricing of inter-company transactions are all easier for the parent to make when dealing with a wholly-owned subsidiary than with one in which the interests of minority shareholders must be taken into account.

49. But problems for the companies are one thing, considerations of national interest another. More disclosure and the opportunity to participate in profits earned by Canadian firms without respect to the ownership of the firms constitute benefits for Canadians. Technical problems in timing and pricing are not relevant in the long-run. A diminution in the parent's flexibility in dealing with the subsidiary <u>may</u> be in the national interest. On the one hand, a Canadian presence via a minority

stock interest increases the likelihood that Canadian viewpoints will be respected. The private Canadian presence is clearly increased. While necessitating companies to allow for minority interests in such matters as inter-company pricing can work to the disadvantage of Canada - for example, by causing the parents to price higher, and closer to true, costs for services provided by the subsidiary since profits have to be shared - the nature of the market economy creates a presumption in favour of letting the market work. Capital market considerations appear to argue for the issuing of equity in Canada by large private companies, most of which are wholly-owned subsidiaries (see below, Capital Market).

50. On the other hand, if loss of flexibility creates significant disincentives for foreign owners to invest new in Canada or expand old investments there will be a loss to Canada of the net benefits from foreign investment. While it is difficult to form a definitive judgment on this point, a relevant question is whether or not minority ownership appears to affect the performance of existing foreign-controlled firms. If there are adverse effects therefrom, then this would argue against minority ownership. The only quantitative study made of this issue - as part of the study

of 280 subsidiaries which has been frequently cited - indicates that there are relatively more Canadian presidents and resident directors when there is minority ownership, but that economic aspects of performance - exports, imports, R & D - are not affected. On the basis of this study, the inference is that a policy of encouraging minority ownership would not adversely affect the economic performance of firms; put differently, there is also no inference that such a policy would improve the economic performance of firms. Finally, as has been pointed out elsewhere (see above, Sources of Economic Growth) none of this proves that the use of scarce Canadian capital to buy minority interests is the best use of that capital; a judgment can only be made on this issue by considering alternative opportunities. (Some aspects of the latter point are considered under Capital Market).

51. In the nature of the case, foreign-owned firms provide returns to foreign owners rather than Canadian owners. The Canadian interest presumably is that returns to foreign-owned firms after tax be as small as is consistent with the efficient growth of the firm. As noted above (see Sources of Economic Growth), there does not appear, on the basis of data that is less than fully satisfactory, to be a

significant difference in profitability between resident-owned firms and non-resident-owned firms, though for a number of industry groupings within secondary manufacturing, profits appear to be higher for the foreign firms. To some extent, this difference may result from the parent firm underpricing for services rendered to the subsidiary. Actual income payments to the parent are not the same as income earned, however, for substantial amounts are retained in Canada to finance the expansion of the subsidiary. Interest and dividend payments have grown in absolute terms, but fallen relative to growth of output and current earnings abroad for the economy as a whole (see Balance of Payments).

52. Foreign-owned companies have paid abroad a variable portion of their current earnings after tax. The average portion distributed exceeded 50 per cent for 1946 to 1951, was just over 40 per cent in 1952-57, and has generally been between 50 and 55 per cent since 1958; it was as low as 40 per cent in 1953 and as high as 63 per cent in 1950. Both the variability of the payments and the substantial reinvestment in Canada are evident. In 1946 to 1961, undistributed profits of direct investment firms were equivalent to

about 40 per cent of the overall increase in direct investment in Canada. Comparisons with resident-owned firms highlight the flexibility of dividend payments by subsidiaries. Whereas in publicly-owned firms it is common to have a regular dividend policy, many parent firms (operating their subsidiaries as private companies), while expecting a return on their investment, may take it at discrete and widely separated points of time. To the extent the parent is willing to agree to postponement of income, the subsidiary may be in a stronger position at times to undertake investments with a longer time horizon in terms of payoff than is the case with its resident-owned counterpart. But flexibility for the parent means it has discretionary power as to dividend payment and this, in turn, means that it may be susceptible to pressures from its government, such as the United States balance of payments guidelines, to vary them in the interests of the balance of payments of the home country rather than the efficient growth of the host country.

53. United States statistics on the sources of funds of United States direct investment companies in Canada show that between 60 and 80 per cent of

the funds used by these firms have come from sources internal to the subsidiary during the past decade, depending on the year considered; net income and depreciation are by far the main sources. Funds from Canada outside the subsidiary have run in the order of 15 per cent, but with a tendency to rise, suggesting that these firms are relying more on local sources of financing. Greater reliance on local sources is one of the directives included in the United States balance of payments guidelines. From the viewpoint of Canada, however, local financing by direct investment firms lessens the initial favourable effects on its balance of payments from foreign investment and, to the extent that local financing is through bonds rather than equity, reduces foreign investment but not foreign control. In order to ensure that excessive reliance is not placed on the Canadian capital market, where the demand for funds has recently been very tight, the Canadian guidelines program includes the reporting of selected financial transactions of larger subsidiaries in Canada.

54. The most important question with respect to the performance of foreign-owned firms is: how efficient are these firms, compared to their

resident-owned counterparts and to their parents? It was previously inferred, on the basis of productivity and price data, that there was no discernible difference in this overall area of performance between subsidiaries and Canadian-owned firms (see above, Sources of Economic Growth). There are other data, however, which indicate that, at least for the larger firms (with assets of $25 million or more), foreign-controlled enterprises as a whole and American-controlled enterprises alone, relative to resident-controlled enterprises, have more employees, pay higher wages and salaries, achieved a higher value of output per employee and per establishment, and have a larger investment per employee. A reasonable inference, consistent with data on specific aspects of performance, would seem to be that subsidiaries are at least as efficient as Canadian-owned firms, and possibly more efficient in several specific respects. In view of the potential benefits to be obtained from direct investment, it might be expected that subsidiaries would definitely outperform domestic firms. Their failure clearly to do so creates a further inference that either the advantages alleged to flow from direct investment are exaggerated or that the Canadian environment is not conducive to extracting maximum benefit from foreign firms. Other evidence in support of the

latter possibility is substantial, and it is, in any event, a sufficient explanation for justifying a broad range of policies to improve the efficiency of the Canadian economy. At the same time, it is clear that foreign-owned firms do not automatically and necessarily perform as efficiently as some of their proponents have claimed.

55. Comparisons of subsidiaries with parent companies leave little doubt that in most cases the unit costs of production of the subsidiary are above those of the parent. A study of Canadian experience in the late 1950's concluded that 57 per cent of the subsidiaries considered had unit costs of production on comparable products higher than those of the parent, in about 20 per cent costs were the same, in 11 per cent typically lower, and in 12 per cent they varied, or the products were not comparable. Larger firms showed costs closer to the parent than smaller firms. A second study of unit costs of American firms and their subsidiaries in Canada in 1960 showed that 20 per cent of the subsidiaries had costs lower than the parent, 29 per cent about the same, and 51 per cent higher, though only one-half of the latter had costs more than 15 per cent in excess of the parent. In the United Kingdom and the European Common Market, unit costs of

subsidiaries were lower than those of the parent in most cases, but the Canadian subsidiary cost structure was better than that in Australia. About half of the firms with higher unit costs for the Canadian subsidiary than the foreign parent cited as the reason shorter production runs, lower volume, and less mechanization resulting therefrom; lack of specialization within establishments, then, was the predominant explanation. Other significant reasons were that the Canadian tariff raised costs relative to those of the parent, and that the subsidiary had higher costs than the parent for some materials and components. There did not appear to be a relationship between age of the subsidiary and level of unit costs relative to the parent, at least after the initial period of establishment, suggesting that cost disadvantages do not tend to disappear with the mere passage of time.

56. The proximate causes of inefficiency of the subsidiary relative to the parent appear to be three-fold. First, the great majority of the subsidiaries, including even the largest firms, are producing items in Canada which are very similar to those of their parents; the capacity to export and the propensity to do research,

however, tend to increase with the degree of product differentiation from the parent. Second, most of the subsidiaries are producing something close to the full product range of the parent corporation, with two-thirds of them producing at least a majority of the affiliates' products in Canada; there is a tendency, however, for firms with a narrower product range to export more and to have a larger domestic content to purchases. Third, the subsidiary companies are much smaller on the average than their parents, almost three-quarters of the firms being one-tenth or less the size and 28 per cent being one-twentieth or less; yet there is a marked improvement in almost every aspect of performance discussed above as the absolute size of the firm increases.

57. There are deeper causes underlying these. Canadian and foreign tariffs induce inefficient production in terms of sub-optimal size and insufficient specialization at the level of the firm and permit of its persistence. The prevalance of American investment in Canada has created a miniature replica of the American economy with too many firms and too many differentiated products. Oligopolistic market structures and the resulting lack of effective competition, further buttressed

by the tariff, permits inefficient firms to survive. The quality of Canadian inputs is inferior to those of the United States; in general, American workers and managers are better educated.

58. It is likely that resident-owned firms would suffer at least as much from such international cost comparisons if they were available. The foreign-owned firm can escape some of the problems of small scale because of specialized goods and services which are available from the parent. The resident-owned firm must be larger than its foreign-owned counterpart to achieve that scale at which all the economies of large-scale operation are available, except to the extent that it can secure these specialized goods and services from others; the available evidence suggests, however, that resident-owned firms on the average are not larger, but probably smaller than their resident-owned counterparts. The causes for the inefficiency of these firms must be in a mixture of tariff-effects and oligopolistic market structures, plus deficiencies in the qualities of Canadian factors of production.

59. In discussing the efficiency of firms, whether subsidiaries or domestic firms, it is important to

distinguish between those in the resource industries and those in secondary manufacturing. The role of the Canadian tariff in inducing and protecting inefficient production is relevant only to the latter. The former are typically export-oriented and must, in that sense, meet world standards of efficiency. The motive for foreign direct investment is not the maintenance of the market share, in the face of a tariff, but market access through vertical integration by primary manufacturing firms or control of Canadian resources through horizontal integration by resource-development firms proper. The achievement of Canadian benefit is less a matter of efficiency than of Canadian participation via taxation and ownership. But just as Canadian policy toward foreign-owned manufacturing firms should be part of a broader set of industrial policies which transcend nationality of ownership *per se*, so Canadian policy toward foreign-owned resource firms should be part of a broader set of resource policies which includes, in particular, policies with respect to conservation and regional development.

60. Canadians have been concerned that the influence of the parent in the decision-making process of the subsidiary may not lead to maximum Canadian development. A definitive analysis is impossible because one can only speculate on how Canada might have developed had foreign direct investment been smaller; even a limited analysis is severely hampered by the inadequacy of data on the existing firms. The most important point about the performance of the subsidiaries is its variability. Sweeping criticisms do not stand up to careful examination. Moreover, where undesirable behaviour appears, as defined by public authorities, it can often be closely related to aspects of the environment within which the firms operate rather than to nationality of ownership <u>per se</u>. At the same time, there are special characteristics of foreign-owned firms which need to be borne in mind by policy-makers.

61. Having fewer Canadians in senior management and on boards of directors than domestic firms, there is less of a private Canadian presence. Being part of a multi-national firm, some decisions - and particularly the most important ones - are made, or at least approved, outside

Canada, lessening both the private and public Canadian presence. This issue will loom larger as rationalization of industry proceeds, since specialization, if it involves integration with the parent, may reduce the role of the subsidiary's officers. Foreign trade performance - which is a critical dimension for the Canadian economy - is generally as good (or as bad) as for domestic firms, but there are problems in connection with restrictive marketing arrangements within international firms (and the extraterritorial application of United States laws) and some evidence of a higher propensity to import. As tariffs decline and Canadian manufacturing becomes more efficient, these constraints will tend to be increasingly felt and more vigorous efforts will be needed to counter them.

62. Research performance is better than for domestic firms, but distinctly worse than for the parents. Insofar as R & D spending is intimately related to the level and character of government support, any policy inference bears on the latter, though with a recognition that the willingness of foreign-owned firms to do subsidized research in Canada needs to be accompanied by provisions that prevent the parent from shifting exploitation of

the research elsewhere in the multi-national firm. Foreign ownership increases the risk that wage settlements may be made that are not in the overall Canadian interest. As rationalization proceeds, it will be necessary to counter increasing tendencies in this regard by insisting on the primacy of lower prices for Canadian consumers. Foreign-owned firms have a distinct disinclination to offer their shares to the public, thereby lessening the private Canadian presence in decision-making and increasing the flexibility of the parents' management. There is no clear evidence that majority ownership worsens performance, but an overall judgment on benefits and costs is not in order at this point.

63. In terms of overall economic efficiency, both subsidiaries and domestic firms have performed unsatisfactorily in terms of the standards set by public authorities in recent years. As these standards are increased, with policy instruments applied to permit of their achievement, all Canadian firms, including foreign-owned firms, will have to strive to improve their performance.

While initiating efforts are governmental, and a continuing public presence is in order, heavy reliance must be placed on private decision-making to implement necessary restructuring in an economy like Canada's.

64. The relevance of the nationality of ownership to the performance of firms is explicitly recognized by the Government's "guiding principles of good corporate behaviour." Issued in March, 1966, these guiding principles bear on the aspects of performance discussed above. Firms are to strive for "maximum competitiveness" and "appropriate specialization" within the international firms. Market opportunities are to be exploited at home and abroad, natural resources processed in Canada where economic to do so, and Canadian procurement sources searched out and developed. A pricing policy fair to both the company and to Canadians is to be pursued, "including sales to the parent company and other foreign affiliates." R & D capacity is to be developed. Sufficient earnings are to be retained to support the growth of the Canadian operation. Firms are to work toward a Canadian outlook within management and include "a major proportion of Canadian citizens on its Board of Directors." Firms are "periodically

to publish information on the financial position and operation of the company" and "to have the objective of a financial structure which provides opportunity for equity participation in the Canadian enterprise by the Canadian public". They are to recognize and share "national objectives" and "encourage and support Canadian institutions directed toward the intellectual, social and cultural advancement of the community."

65. Communications from the government to the Canadian subsidiaries stated that there was already widespread adherence to the principles among the subsidiaries in Canada, but added that there was room for improvement. Replies were invited from the companies. The great majority of companies accepted the principles; in the great majority of cases, they indicated they conformed, but in a minority of cases only that they agreed. The wording of the principles - with frequent use of "appropriate" and similar phrasing - and the tendency of companies to reply in generalities, in the absence of a specific questionnaire - lend a certain impressionistic aura to the results. At the same time, some significant nonconformity and disagreement emerged. A

significant minority of the firms did not conform with the guiding principle on the development of technical research. Most of the firms did not conform with and did not agree with the very specific principles regarding financial reporting and stock issue.

66. Any effect of the guiding principles on the future behaviour of foreign-owned firms will result to the extent that exhortation per se can be expected to influence behaviour. It is appropriate for governments to use techniques of "moral suasion", and the great majority of replies from the companies show serious intent to take exhortation seriously. At the same time, as was noted above in the discussion of availability of information, the functions of economic analysis and of surveillance cannot be properly met in this way. For that reason, it was suggested, first, that D.B.S. collect data on a confidential basis from both foreign-owned and domestic-owned firms that would permit of comparative analysis of the behaviour of foreign-owned firms; and second, that a more detailed and compulsory questionnaire be sent to foreign-owned firms by an operating department or agency of the

government so that the surveillance function can be met. Within this context, the present guiding principles of good corporate behaviour could be retained, and the subsidiaries periodically invited to comment on their degree of agreements and conformity therewith. Some benefit can be expected from the use of moral suasion, while open-ended replies from the companies provide a worthwhile feedback.

Licensing and Joint Ventures

67. The transfer of knowledge that accompanies the transfer of capital in direct investment operations provides benefits to recipient countries. Could such advantages be obtained through other means which might be more acceptable to the host country? Two specific means which are alternatives to direct investment are licensing agreements and joint ventures. When a foreign firm decides to produce in Canada, it can choose to establish a Canadian subsidiary, or to license an independent Canadian firm to manufacture its products, or enter into a joint equity venture with an independent Canadian firm. Whether these alternatives are efficacious from the viewpoint of the host country depends on how firms in fact perform.

68. Licensing agreements can be between associated firms, that is, between a parent and its subsidiary, or between independent firms; only in the latter case are they substitutes for direct investment. Also licensing agreements can take a variety of forms, from the mere granting of use of a patent or trademark to complex agreements involving an active contribution of the licensor to the assets and management of the licensee; agreements of the

latter type become joint ventures proper.

69. It is very difficult to get precise information on the number and nature of licensing agreements. Surveys of the practices of American firms indicate that licensing agreements with foreign firms are widespread, including both independent producers and associated companies and the former apparently predominating. Agreements involving the simple use of a patent or trademark are the most frequent, but there is evidence of a trend to the more complex agreements. A significant number of licensing agreements by United States firms are with Canadian firms, though including subsidiaries. American data indicate that Canada ranks first for royalties and fees received by the United States from American subsidiaries abroad. There is a clear need for improvement in the quality and quantity of information available to government on licensing agreements entered into by independent Canadian firms.

70. Licensing agreements can be examined from the viewpoint of the licensor, the licensee and the host country. The preference of American firms (as potential licensors) is clearly for direct investment rather than the licensing of independent firms. Licensing agreements are typically considered

to be effective when establishing a subsidiary is not possible or desirable. Where licensing is chosen, the motives vary. Where patented techniques diffuse easily and rapidly become obsolete, licensing becomes more attractive as a means of maximizing revenue and distributing the cost of research. Licensing an independent producer as an alternative to establishing a subsidiary economizes on the firm's capital and management and is attractive where the supply of the latter is constrained. This technique also facilitates entry to a market when barriers to entry of new firms are difficult to overcome, and permits of local testing of a market before investing in it. Also a licensing agreement may be a cross-licensing agreement providing for a two-way exchange of information, so that the "licensor" gains reciprocal access to the "know-how" of the "licensee"; in situations of rapid and unpredictable technological change, the cross-license is attractive. From the licensee's point of view, the benefit is the gaining of access to superior technology while remaining free to choose the products or methods of particular interest. The financial cost is the royalty paid which, on straight licensing

agreements, is typically in the order of 5 per cent of sales.

71. The interests of the host country transcend those of both licensor and licensee. To the extent that the licensor does not share in the profits of the licensee and has licensing arrangements with firms in many countries, the licensor firm will try to clearly specify rights under the license and may, while giving exclusive rights to the licensee for the latter's own home market, exclude it from export markets. While no comprehensive data exist on the prevalence of this practice in Canada, it is probably widespread, and, like other restrictive trade practices, is probably not in the national economic interest. (The legality of restrictions included in many licensing agreements is currently under study by the United States Department of Justice). More generally, benefits and costs inhere in licensing agreements from the perspective of the host country. On the one hand, insofar as licensing of an independent domestic firm is a substitute for a foreign subsidiary, Canadian ownership is more than it would otherwise be. On the other hand, if the licensee rents foreign technology and neglects its own research and

development, Canada will be independent in terms of ownership but not in terms of innovative capacity.

72. The implications for policy would seem to be two-fold: first, much more information is needed on licensing agreements; and, second, licensing agreements can be presumed to be a useful alternative for Canada in some cases, provided that the Canadian firm has freedom to export. Means should be found to exercise effective surveillance with respect to the latter, both by collecting information from firms on a compulsory basis and policing restrictive practices. In view of the specific nature of the problem, a possible procedure would be to have mandatory filing of the terms of all licensing agreements with an operating department or agency of the government and to make each such agreement subject to government approval. The latter arrangement would permit of some flexibility in tolerating export restrictions where other benefits warrant.

73. The more complex licensing agreements border on joint ventures proper. The latter are defined for present purposes as joint equity ventures involving the participation of two or more firms in

another firm's capital stock. Few studies exist on them and none for Canada. Of 2,641 financial complexes identified from CALURA data for 1964, about 350 are joint equity ventures where the parents have equal, or almost equal, participation. Only 52 of these, however, are between Canadian and foreign firms, with most of the remainder being joint ventures between Canadian firms only. Of the 52, only a few are major firms. It is clear that joint ventures do not play an important role in Canada. While at the world level joint ventures are becoming more widespread in recent years, foreign firms tend to emphasize their disadvantages and drawbacks more than their advantages. From the viewpoint of the firms, the joint venture's obvious advantages are those which accrue from pooling, such as risk reduction, sharing of knowledge and techniques, ability to enter into larger and more complex operations, and diversification by the firms. Two other "advantages" sometimes cited by American firms are that entering a joint venture leaves them less open to charges of merger to restrain competition - though they are not free of such charges, either in principle or in law - and that, by making a concession to the nationalism of the host country, they receive better treatment. But disadvantages inhere in joint

ventures from the viewpoint of the firms simply because there is no single controlling authority. The two or more firms involved can have differences of opinion regarding the objectives of the joint firm. The disposition of profits is a frequent bone of contention and conflicts in this area may sap the growth potential of the firm. Management is made difficult if the capital is equally divided with equal representation on the board of directors, and there may be costly periods of hesitation and inactivity. While these drawbacks are real, so are the advantages, and with the latter presumably dominating in enough cases to explain the recent trend in favour of joint ventures.

74. Objections of firms notwithstanding, joint ventures may be in the national interest of the host country. Participation by a domestic firm with divided control can be preferable at times both to the wholly-owned subsidiary with no resident control, even if the latter arrangement is more efficient in the short-run, and to a wholly resident-owned firm which is simply less efficient and creates fewer economic benefits. While the small number of major joint ventures in Canada suggest that they are not an important alternative to foreign ownership

proper for Canada in the near future, there is almost certainly scope for their increasing use. Both the government and the proposed Canada Development Corporation could enter into joint equity ventures, particularly in large-scale resource developments.

Conclusion

75. There are serious deficiencies in the information available on the performance of firms, foreign and domestic, in Canada. Information available to the public on the activities of corporations, including some of the largest corporations in Canada, is grossly inadequate. Information available for purposes of economic analysis is generally very good, though some improvements are possible. Information available for the surveillance of firms, and particularly with respect to some special problems resulting from foreign ownership, is inadequate. Improvements are needed across a broad front and a number of specific initiatives by the federal government are in order with respect to company law, bankruptcy law, securities legislation, CALURA and the guiding principles.

76. Analysis of the performance of firms indicates that foreign-owned subsidiaries perform more or less the same as Canadian-owned firms but distinctly worse than the foreign parents. These findings imply that the environment within which firms operate is more relevant than nationality *per se* for many aspects of their performance, and that

the benefits alleged to result from foreign ownership are not as large as they might be. Both subsidiaries and domestic firms in many secondary manufacturing industries are inefficient in terms of the standards set by public authorities.

77. There are some special characteristics of foreign-owned subsidiaries - for example, fewer Canadians in senior management and on boards, restrictive marketing arrangements within international firms, a distinct disinclination to offer shares to the Canadian public, susceptibility to the policy of foreign governments - which need to be borne in mind by Canadian policy-makers. Though in need of much revision, Canada's program of guiding principles to the foreign subsidiaries is an important first step in recognizing that nationality of ownership of Canadian corporations can be a determinant of certain aspects of corporate behaviour and that it is necessary to have machinery for surveillance of foreign subsidiaries.

78. Licensing of independent firms and joint ventures deserve more attention than they have

received in Canada as alternatives to the wholly-owned foreign subsidiary. The efficacy of licensing agreements would be increased by prohibiting restrictions on freedom to export. Joint equity ventures have some potential for facilitating Canadian participation, as in large-scale resource developments.

v. Balance of Payments

1. Foreign investment in Canada will in almost all cases affect the balance of payments. Even the reinvestment of earnings by subsidiaries, which has no direct effect on the balance of payments, may have several indirect effects. For example, such reinvestment raises the base from which future earnings and dividend payments arise.

2. The effects of foreign borrowing on the balance of payments are a major concern for many countries of the world today. One can distinguish throughout the post-war period a threefold classification of interest in international capital movements. First, there is the concern for balance of payments reasons. In this regard, the major concern is often the ability of a country to maintain a viable payments and reserve position in the face of large-scale flows on capital account, whether of a short-term or long-term nature. The second reason is the concern about the implications for the national interest of an increasing degree of foreign ownership of industry through large-scale direct investment. Finally, there is the interest in the effectiveness of long-term international capital flows in promoting more

rapid economic development. This section deals with the first of these points only, the other points having been dealt with elsewhere.

3. An inflow of foreign capital leads, via price and income changes, to an increase in imports and/or a decrease in exports equal to the amount of the inflow (except for certain short-term compensatory moves by the monetary authorities), that is, the current account moves toward deficit. A persistent deficit in current account, as a characteristic of the Canadian balance of payments, results automatically from persistent capital inflow, and is not *per se* a sign of weakness in the Canadian balance of payments. Furthermore, the historical evidence is that the mechanism of adjustment which equilibrates the Canadian balance of payments works well to offset changes in any one item, including increases or decreases in the inflow of long-term capital.

4. Portfolio capital movements should be distinguished from direct investments since the effects of the latter are more widespread than those of the former. Direct investment inflows increased considerably after 1950, and, with some exceptions, have been even more important than long-term portfolio investments since then. The

analysis will concentrate on the affects of foreign direct investment on the balance of payments, since it is direct, rather than portfolio, investment which is the primary concern of this Report.

5. Direct investment affects not only the capital account, but also the merchandise account of the balance of payments. The latter will almost inevitably be affected by the entry of a foreign-owned firm. At the moment of entry part of the necessary equipment is often imported from abroad. Furthermore, there are usually imports of services (such as managerial services and research) when a foreign subsidiary enters Canada. Once production has started, components and parts and various services will continue to be imported. Canada's dependence on the rest of the world, and particularly the United States, for imports not only of consumption goods but also of components and parts is well-known. This is a characteristic of most firms that are located in Canada and not simply of the foreign-owned subsidiaries. As noted above (see <u>Performance of Firms</u>), however, non-resident owned firms appear to have a greater orientation to imports than resident-owned firms. Data on the larger foreign-

owned firms derived from the guiding principles questionnaire show total imports of about $2.7 billion in 1965.

6. But foreign investment also brings access to markets abroad and will likely result in increased exports. This has been very clear in resource-based industries. It has been less obvious in recent decades as far as foreign investment in Canadian secondary manufacturing industries is concerned. Such firms in many cases are not able or not likely to export, largely because the costs of production and transfer abroad, including foreign trade restrictions, are too high, but also in some cases because export franchises are limited by the licensing agreements made with parent companies. Nevertheless, data on the larger foreign-owned firms derived from the guiding principles questionnaire show total exports, including those of the resource-based industries, of about $2.7 billion in 1965. A complete picture would also require information on the exchange-saving effect resulting from the local production of goods that were previously imported; no satisfactory estimate can be made of this effect in the present state of knowledge. The comparison of Canadian production with exports from the United States,

on the basis of published American information for a few sectors only, suggests that this effect has been substantial.

7. The relationships between the capital account and service transactions are also significant. The main concern with respect to portfolio capital movements is the servicing of the debt, that is, the payments of interest and dividends abroad. But direct investment flows are inextricably associated with the transfer of technology and have effects going beyond debt servicing. This type of investment tends to integrate more closely the economies of the investor country and the recipient country. It is reasonable to think, for instance, that the intricate relations between subsidiaries and parent companies or other affiliates result in higher travel and freight expenses than would otherwise be the case. The balance of payments statistics do not permit an estimate of the magnitude of these expenses. However, estimates are available of payments for royalties, fees and other types of business services closely related to direct investment.

8. As far as payments of interest and dividends are concerned, one should distinguish between three problems. First, borrowing abroad through bond issues will result in payments of interest abroad

and the reimbursement or refinancing of capital in due time. Second, direct investment will result in the payment of dividends and business services payments of various kinds. Third, there is the possibility of the investor country repatriating the capital invested abroad if it wishes to do so, and this may create strain on the exchange reserves of the host country. Barring a great depression, substantial repatriation by the investor country seems unlikely, though American balance of payments policy, particularly since January 1968, is tending to move toward such a possibility.

9. As for the first point, the relations between inflows and outflows of funds that would result from continuously borrowing abroad depend on assumptions about different rates of returns and various amortization rates. Given the compound interest process the outflow of funds from the borrowing country can very soon become quite substantial, so that it is possible for a country to be forced to borrow abroad to service the external debt. The rise of direct investment has focused attention on dividend payments abroad. These amounts may also become quite substantial rather quickly since the initial investment brings

profits which are partly reinvested and on which dividends will be paid at a later date. Interest and dividend payments abroad by Canada have increased considerably from 1946 to 1966. These payments amounted to $312 million in 1946; in 1966 they totalled $1,178 million leaving a deficit for this item only of close to $900 million. In absolute figures these amounts are high and growing.

10. When related to the growth of output and current earnings abroad which help finance them, however, interest and dividend payments have been declining. As a percentage of gross national product, they have fallen from 2.9 per cent in the late 1920's and 6.4 per cent in the depressed 1930's to 1.9 per cent in 1957-65. As a percentage of sales of goods and services abroad, they have fallen from 16 per cent in the late 1920's and 25 per cent in the 1930's to 9 per cent in 1957-65. These payments of interest and dividends, moreover, include all payments by both resident-controlled and non-resident controlled firms as well as Canadian governments. Only a portion of these payments result from direct investment as such. Thus, in 1964, the latest year for which data are available, direct investment firms paid

abroad \$562 million out of total payments of interest and dividends abroad by all residents of \$1,010 million. (Residents also received \$188 million on direct investment account out of total receipts of interest and dividends of \$332 million). In addition, such companies re-invested earnings of \$455 million in Canada, which is not shown as a debit in the balance of payments but does raise Canada's foreign indebtedness and the base on which future dividends are paid. Finally, \$58 million was paid as withholding taxes to the Canadian government. Total earnings by direct investment firms in 1964 after corporation income tax were \$1,075 million, of which 52 per cent was paid abroad.

11. It is sometimes alleged that, from a balance of payments point of view, dividends should be preferred to interest since the latter are a fixed charge which might become relatively heavy when the rate of growth of the economy is decreasing. It is true that in recent years Canada has faced continuously increasing interest payments while dividend payments have shown much wider variations from one year to another. The result has been the increasing relative importance of interest payments; in 1946 these payments amounted to 67 per cent of

the dividends paid abroad, in 1956 to 32 per cent, in 1959 to 45 per cent and in 1960 to 58 per cent. This last percentage has been fairly stable up to 1966.

12. The alleged advantages of dividends from a balance of payments point of view should not be exaggerated, however. First, it is generally agreed that another depression like that of the 1930's is improbable, and this makes the rigidity of interest payments less important. Second, direct investment is concentrated in the larger Canadian corporations which have grown rapidly. Since their size is partly due to the degree of mechanization, they pay less for wages per dollar of value added; hence their profits and capital costs, and potential payments abroad, are relatively large. Finally, bond financing involves fixed and known liabilities which automatically come up for repatriation, if that is preferred to refinancing, at a point of time. The liabilities assumed with direct investment are indeterminate, will increase if the firms are successful, and are flexible depending on the needs of parent and subsidiary. While firms can be repatriated by acceptable bids, there is

no fixed time or price and many are so closely integrated with the parent that repurchase is difficult. It is likely for these reasons that the balance of payments debits arising from direct investment will continue longer than those from debt investment. They may also be higher, though this aspect is complicated by the fact that more than capital is received with direct investment.

13. Next to interest and dividend payments and receipts, the most important item in the deficit of the Canadian balance on current international account has been that associated with "other current transactions". The largest single item involved here is payments for business services resulting from the relations between foreign-owned firms in Canada and their parent companies abroad. When a foreign firm undertakes an investment in Canada, part of the initial expenses will be for designs, engineering services, blueprints, production methods and industrial processes and sometimes for the location of specialized equipment. Once the operations have started, payments of royalties, management fees, payments for research, advertising, and accounting services may become important. Although independent Canadian producers also purchase these kinds of services from abroad,

most of these payments are the result of foreign direct investment in Canada and must be considered as a cost of the technology and management that is brought by it. Unfortunately, the balance of payments does not show the totals of such business service payments and receipts separately, whether overall or for direct investment companies alone. The most inclusive estimate is that compiled under the Corporations and Labour Unions Returns Act. In 1963 companies whose capital was over 50 per cent owned abroad paid non-residents $228 million for royalties, franchises, advertising, research, insurance, premiums, management fees, salaries and other professional services. These include payments to parents and to other non-residents. No earlier or more recent figures are available. The corresponding payments abroad by resident-owned firms were $54 million. The 266 larger foreign-owned firms responding to the guiding principles questionnaire paid abroad $251 million for such business services. Fully $153 million of this went to foreign parent concerns. These data probably understate the real value of such services, with the parent being reimbursed instead by higher profits and dividends than would otherwise be the case.

14. When account is taken of all these elements, the effect of foreign investment on the balance of payments of the debtor country in the long-run will likely be more widespread and more important in the case of direct investment than in the traditional case of portfolio capital movements. There is no satisfactory evidence available to assess the overall effects of direct investment on the Canadian balance of payments. There are, however, statistics on the actual contribution to the balance of payments by foreign-owned firms for two years collected by the guiding principles questionnaires. These data, which necessarily refer to direct effects only and neglect a number of indirect effects, and are subject to a number of other limitations, suggest something as follows. There is a substantial deficit in the foreign trade of (the larger) foreign-owned firms in secondary manufacturing industries in Canada, which is at least offset by a substantial surplus in the foreign trade of (the larger) foreign-owned firms in primary products and primary manufactures. There is a substantial deficit for these firms in trade with the United States on the one hand and with all foreign affiliates on the other, which is at least offset by trade with other countries and non-

affiliates. These firms have a net deficit on interest, dividend and business services account so their direct effect on the current account would appear to be negative. They import capital net, however, so their direct effect on the foreign exchange position may be close to zero.

15. These figures do not yield the information really required, namely, the long-term effects of direct investment on the Canadian balance of payments. This would require a systematic econometric study of the effects of direct investment in primary industries and primary manufacturing on the one hand and secondary manufacturing on the other. It would examine the effects on capital inflow, foreign trade, income and other accounts stage by stage, from initial investment to operation of the facilities over time. No such study is available for Canada.

16. Several systematic studies have been made of this process elsewhere. One such study attempted to evaluate the effect on the United States balance of payments of a $1,000 direct investment in European manufacturing industry. Each year, except for the year of the investment, there was a net positive effect on the United States balance

of payments. The net cumulative effect became positive during the sixth year. This need not mean, however, that the effect on the European balance of payments is negative in proportion; American manufacturing affiliates in Europe are highly oriented to exports but not necessarily or only to exports to the United States. Another such study traced the effects on the United Kingdom balance of payments of direct investment abroad as compared with a situation where such investment was not undertaken by a British company. This too gives a favourable continuing effect on the British balance of payments but a much smaller one than in the American study, so that it takes much longer to reach a cumulative net positive effect from the point of view of the United Kingdom. Moreover, the fact that the continuing effects are positive at all depends heavily on very above-average performance by a few industries. The initial and continuing effects also differ significantly by the host country. While both of the above studies indicate positive effects on the investing countries' balance of payments over time, the differing industry and country

effects suggest one must be careful in inferring the long-run effects on the balance of payments of any particular recipient country.

17. A similar study should be undertaken for Canada in order to determine whether the probably negative long-run effects on the balance of payments of direct investment in secondary manufactures are likely to be offset by the probably positive long-run effects of direct investment in primary industries and primary manufactures. This study would have to be conducted within the larger context of the probable long-run balance of payments situation more generally. There is no reason why any one sector, such as the foreign-owned sector or the resident-owned sector, should have a continuing neutral effect on the balance of payments. There is a necessity, however, if any one sector persistently tends toward a deficit on combined current and long-term capital account, for policy to be so oriented over time as to yield approximate balance in these accounts for all sectors together. Otherwise the country will persistently accumulate short-term assets or liabilities with destabilizing effects.

18. In a long-run context, the maintenance of a viable balance of payments depends largely on the existence of an appropriate set of overall economic policies. Of particular importance in this respect are policies designed to increase efficiency in Canada. It seems clear that such policies would strengthen the Canadian balance of payments in the long-run. For much direct investment - and resident-owned industry as well - in secondary manufacturing, rationalization should be pursued to achieve more efficient and specialized production on an international level with the expectation that Canadian capacity to export will be increased. But where there is reason to believe that Canadian production cannot be made efficient at world standards, even in the long-run, importation should be considered as a possible alternative to subsidized direct investment; a proper concern about the balance of payments need not degenerate into an obsessive fear of imports.

19. While this section has focussed largely on the balance of payments in the long-run, it is not intended to deny that reliance on imports of capital creates short-run problems for policy-makers. For the latter, indeed, the long-run

is a succession of short-runs. The plight of the policy-maker is sometimes put in terms of the vulnerability of the Canadian balance of payments, given a large and persistent deficit on current account which has to be financed. Since the deficit is more clearly caused by the capital inflow than the reverse, the problem could be more accurately expressed as the straight-forward fact that if a country develops with foreign capital, it wants a stable inflow.

20. Large and persistent capital inflows tend to create an economy and a set of economic policies predicated on the assumption that the inflows will be stable. Instability compels adjustments which may ramify throughout the economy, and which may be costly economically - and politically. The mechanism by which the balance of payments adjusts varies with the exchange rate system used, whether fixed or flexible. It can be argued that, for Canada, a free rate is to be preferred insofar as reliance on a fixed rate may compel the use of monetary-fiscal policies to equilibrate the balance of payments, thereby inhibiting their use to control fluctuations of income, prices and employment in the economy.

21. In both the short-run and the long-run, the balance of payments of one country, and its policies with respect thereto, are necessarily closely related to the balance of payments of other countries and their policies. Of particular importance in this respect for Canada is the United States balance of payments and United States balance of payments policies. In recent years, the American balance of payments has been in some difficulty and, at least in the near future, is likely to remain so. The United States has properly adopted policies designed to alleviate this problem, and, insofar as the Canadian balance of payments is relatively strong, there should be no objection from Canada.

22. But this is not to say either that Canada must approve of the particular choice of means that the United States might adopt, or that overall Canadian economic policy should not be reexamined in view of the state of the American balance of payments and the nature of American balance of payments policies. The United States has chosen to put a ceiling on new outflows of direct investment, originally on the basis of voluntary compliance by American corporations but, beginning January 1968,

by compulsory controls. The United States has further chosen to issue directives to the parent companies to have them alter the behaviour of their subsidiaries in ways that will bolster the American balance of payments. These directives were initially simply guidelines to the firms, but since January 1968, those relating to the repatriation of earnings have become mandatory controls. The willingness of the United States to attempt to use foreign subsidiaries as instruments for American economic policy raises questions about the nationality of multi-national firms and overlapping jurisdictions which are discussed below (see <u>Politics of Private Foreign Investment</u>).

23. The possibility that the United States has balance of payments problems which will persist suggests the desirability of Canada considering whether it should continue to order its affairs on the assumption of the easy availability of American direct investment. The United States balance of payments controls of January 1968 on new direct investment outflow, while putting Canada in a preferred-country status, nevertheless may mean that American direct investment will not

grow in pace with the Canadian economy, and will therefore reduce the relative contribution of American direct investment. The case for new national policies designed to strengthen the capacity of the Canadian economy to generate growth internally is made more compelling by the recognition of the fact that Canada may have to get along at least in the near future with less American direct investment than it would otherwise presumably have received.

24. The possibility that the United States will persist in attempting to solve its balance of payments problem in part by regarding subsidiaries as instruments of American policy must be resisted by Canada in principle, and must be met by countervailing instructions to American-controlled subsidiaries in Canada. American policy, to the extent that it causes Canadian subsidiaries to pay more to their parents than they otherwise would, can be presumed to interfere with the efficient growth of the subsidiary and hence with the Canadian economic interest. A most important feature of the present guiding principles questionnaire to the larger foreign-owned subsidiaries is the collection of information

on abnormal financial transactions with the parent which may be the result of United States directives. This feature must clearly remain central in any revision of the questionnaire. As suggested previously (see Performance of Firms), the Canadian guiding principles questionnaire should become mandatory and the principles operational. While such a policy step can be supported without respect to American balance of payments policy, the increasing stringency of the latter makes the case compelling for an economy as open as Canada's and so intertwined with the American economy. American direct investment controls constitute, in effect, selective foreign exchange controls. The prospect must be faced that should these controls threaten to have significantly adverse effects on the Canadian economy, Canada would have also to move to suitable countervailing policies.

vi. <u>Capital Market</u>

1. No sector of the Canadian economy is more deeply involved in the foreign investment issue than the capital market. It is the market for capital which provides the mechanism through which Canadian governments raise much of the money they need to finance deficits, through which Canadian corporations supplement internal sources to finance capital expenditures, and in which many of the security transactions between resident and non-resident buyers and sellers take place. Any policy recommendations that might be put forward with respect to foreign investment necessarily have a direct impact on the financial markets.

2. The Canadian capital market has been in existence for a long time, is large and sophisticated, and has played an important role in Canada's economic development. At the same time, it has developed very much in the shadow of the New York capital market, which is the dominant world market. Canadian market prices tend to move in close parallel to American bond and stock prices, and most Canadian lenders and borrowers or security buyers and sellers also

participate to some extent in the American market. The closeness of the relationship between the two markets exists, however, in the context of a Canadian financial business still largely run by independent Canadian firms.

3. The major concern for present purposes is not with the ownership of institutions in the investment business, but with the effectiveness, or otherwise, with which the Canadian capital market functions now and might be expected to function in the future in providing Canadian savers with outlets for their funds and Canadian borrowers with finance. The relevant questions are: What gaps, if any, are there in the machinery for mobilizing Canadian savings? Are the changes that are currently taking place in the market likely to affect the market adversely? Is the depth of the Canadian stock market affected by an inadequate supply, quantitatively and qualitatively, of Canadian issues? Why have Canadians invested so much in American stocks in the past few years? What is the potential Canadian demand for common stocks in the future?

Entrepreneurial Capital

4. Is there a gap in the machinery, or institutions, of the Canadian capital market? Canada is well-endowed with institutions which mobilize savings and channel them into investments - banks and other deposit-taking institutions, insurance companies, open-end investment funds or mutual funds, pension funds, stock exchanges, and closed-end funds. Most of these institutions have flourished in recent years, as Canadians have placed a substantial portion of their growing savings in these financial intermediaries. Nevertheless, it can be argued that a gap exists with respect to what can be called "entrepreneurial capital", that is, capital which is allied directly with entrepreneurial skills and takes an active part in the development and management of enterprises in which it invests. The question of whether there is a gap in the capital market can be rephrased as: do the institutions mobilize an adequate volume of Canadian savings for purposes of entrepreneurial investment?

5. Most financial intermediaries, important though they are, do not, and by and large should not, play such a role. They are lenders, like the

banks, or passive investors in diversified portfolios, like the mutual funds, pension funds and insurance companies. An important exception is the closed-end funds which issue their own securities and typically invest their capital with the objective of exercising influence or control, that is, they provide to the companies in which they invest not only capital but entrepreneurial and management skills and they provide to Canadian investors not only ownership but also control. Though an examination of these closed-end funds, or holding companies, shows the development in the past few years of new sources of entrepreneurial power and an extension in the activity of existing sources, this type of institution remains small in relation to the other financial institutions in Canada. The closed-end funds have grown much more slowly than the other main institutional equity buyers, notably mutual funds and pension funds.

6. As a result of their different objectives and methods of operation, the closed-end funds suffer from some serious market disadvantages compared to mutual funds, and their shares tend to sell at a substantial discount from "break-up" value, that is, from the value of the component

investments reduced by fixed liabilities and preferred stock. The closed-end funds suffer the double handicap of specializing in growth situations which normally pay less income than ordinary commons, and of having higher operating costs because of their managerial role. They also face difficulties in distributing capital gains. Capital gains made by mutual funds are reflected immediately and fully in the price of their shares, and shareholders can redeem and receive their capital gains. Appreciation in the value of the portfolio of a closed-end fund works its way through slowly to the investing public as a result of the delay in publication of periodic break-up values; in any event, the usual closed-end discount on the value of the gain applies. From the viewpoint of the closed-end funds, all their realized profits must be taken into surplus as an investment reserve; they are unable to offset some of their disadvantages by distributing tax-free capital gains to shareholders.

7. Consideration should be given to specific steps which would facilitate the closed-end funds in the important role they play. One possibility is that they be given the right to buy in their own stock under certain controlled conditions.

Such purchases would tend to eliminate the discount and improve the marketability of the stock. The United States Investment Companies Act permits such purchases under specified conditions, and this may partly explain the narrower discount which prevails on shares of American closed-end funds. Another possibility is that the closed-end funds should have the right, if they so elect, to declare and distribute their capital gains without penalty.

8. A shortage of entrepreneurship in Canada is a serious obstacle to Canadian economic development and is both a cause and a consequence of reliance on foreign direct investment (see above, Sources of Economic Growth). The mobilizing and efficient use of this scarce resource is of the first importance. No lowering of dependence on foreign corporations is possible unless Canadian entrepreneurship is improved at the same time. Among other things, this requires institutions with the ability to mobilize large quantities of capital, search out investment opportunities, and oversee diverse activities. In short, something is needed in Canada to fill the function performed by the corporate structure of the multi-national enterprise. One source of

this ability is Canadian-owned business corporations and holding companies, and some of these are equal in ability to any in the world.

9. But more is needed. Few Canadian companies can hope to attain the size of a number of the existing giant foreign-based firms and have the capacity to undertake the projects that fall within the purview of giant firms. Canada is not so well endowed with entrepreneurial talent that it can afford to spread it thinly across a broad front. By concentrating this scarce resource to some extent, it would become possible to initiate projects that might otherwise go by default to foreign corporations. The "technological gap" alleged to separate most of the world from the United States may, in fact, be largely a "managerial gap". Even when American leadership is based on technological superiority, the relevant issue is how to speed the diffusion of techniques, and the process of "creative imitation" hinges critically on the quality of local entrepreneurship. Also, experience elsewhere suggests that it is politically undesirable to concentrate too much economic power in the hands of large private

companies, however competently run. These considerations suggest that a case can be made for a new institution along the lines of the much-discussed Canada Development Corporation.

10. From this perspective, the proposed Canada Development Corporation should be a large holding company with entrepreneurial and management functions, assuming a leadership role in Canada's business and financial community in close cooperation with existing institutions. It would be a Canadian analogue to the giant American corporation. Its size and its quasi-public character would enable it to make a unique contribution in organizing consortia of investors, domestic and foreign, thereby carrying out large projects beyond the capacity of a single institution and throughout maintaining a clear Canadian presence. Its capacity to draw on the expertise of the financial community and to provide a focal point for the mobilization of entrepreneurial capital would help to meet what is presently a major flaw in the Canadian capital market, namely, that rising Canadian ownership of equity securities does not appear to be matched

by rising Canadian control. Its existence would mean an additional vehicle for the investment of Canadian savings with assurance of a Canadian presence in decision-making.

Shortage of Canadian Equities

11. Recent stock market developments also raise questions about the viability of the Canadian capital market. The last few years have been marked by two substantial flows in equity securities across the Canadian border, a repatriation of Canadian stocks held by foreigners, and a rising investment in American equities by Canadians. It is estimated that the former (net) averaged $117 million in 1961-64, rose to $242 million in 1965, fell to $83 million in 1966 and was $66 million in the first eight months of 1967. The latter is estimated to have averaged $27 million in 1961-64, risen to $92 million in 1965 and to $245 million in 1966 and to have been $127 million in the first eight months of 1967. While there is no way of reliably identifying the buyers of the repatriated Canadian securities, Canadian investment in foreign, mainly American, stocks is substantially accounted for by the mutual funds. The latter have grown very rapidly in recent years, and at the same time they have increased substantially the portion of their portfolio going into foreign stocks, to the

point that their foreign stock holdings are now about equal to their holdings of Canadian stocks.

12. Sales of Canadian stocks by foreigners reflect the impact of the 1963 United States Interest Equalization Tax on United States buying of Canadian stock, a change in United States tax laws which made Canadian securities less attractive for non-resident owned investment funds, and, in general, some dissatisfaction with Canadian stocks as an investment medium. In 1966, the net repatriation slowed, but it is possible that the diminished flow is only a temporary phenomenon, with further sales by foreign holders awaiting the recovery of Canadian stock prices.

13. A number of explanations have been offered by market participants for the recent sharp increase in Canadian interest in American stocks: lack of choice in Canada; lack of depth in Canadian markets which makes it difficult for institutions to buy and sell in large amounts - a situation which is then worsened by the trend toward American stocks; lack of "action" in the Canadian market, with investors being increasingly drawn to more active trading and the fast moving stocks of which the

United States market has a greater number; less restrictive securities regulations in Canada and less disclosure by Canadian companies, making Canadian issues less attractive; and allegations that Canadian management is inferior, with too many Canadian companies run by an aging group of "established executives".

14. The first three of these reasons suggest another, and widely held, view, namely, that both the spillover of Canadian interest into the American stock market and the large repatriation of foreign-held Canadian stocks are due primarily to an inadequate supply of attractive Canadian issues to meet the sharply growing demand for equities by Canadian investors. "Attractive" has special connotations for the Canadian investor because of his exposure to American stocks and markets; comparison of Canadian stocks with American stocks is inevitable, the Canadian dividend tax credit notwithstanding. Such a comparison shows a range of "glamour" issues in the United States market - in data processing, photocopying, airlines, research, electronics, space technology and communication - where recent performance has

been exceptional. In all of these industries, few Canadian stocks are available. The few that have been available have tended to perform well, while most traditional Canadian blue chip securities have paralleled the less impressive, though steady, performance of their United States counterparts. It is estimated that nearly one-half of the foreign stock portfolios of Canadian mutual funds is in two industries, office equipment (broadly defined) and airlines, and these industries have virtually no representation among the largest listed Canadian stocks. Another third of that portfolio is in six industries that are either not listed among the largest listed Canadian stocks or are represented by only one or two companies.

15. There is clearly something to be said for the view that the swing of Canadian investors to United States issues is due mainly to a fundamental shortage of Canadian equities, at least of the type of issue that Canadian investors want, in the face of sharp increases in demand for equities by Canadian investors. The supply problem is not new, yet prior to 1961 Canadians were typically net sellers of foreign stocks while foreigners were net buyers of Canadian stocks. The new feature of the situation is the very large

increases in demand, particularly by the mutual funds and the pension funds, which have pushed Canada into a deficit position in equities.

16. The prevalence of the wholly-owned subsidiary in Canada in the form of private companies, as well as the existence of Canadian-owned private companies, neither of which offer their shares to Canadians, means that the supply of publicly traded Canadian equities is less than it would otherwise be, and that the Canadian capital market for equities is not as fully developed as it would otherwise be. Of the 375 non-financial corporate groups referred to above, only 60 per cent have a publicly traded preferred or common stock issue. It is estimated that the market value of 169 of the largest identified private company complexes was approximately $12 billion at the end of 1965, and something less than this at the end of 1966. It is further estimated that the market value of all listed stocks of Canadian corporations was almost $36 billion at the end of 1966.

17. While estimates concerning private corporations are subject to a considerable margin of error, they suggest that the market value of 169 of the

largest private companies is in the order of one-third the market value of all publicly traded stock of Canadian corporations; if all private corporations were considered, this proportion would be much larger. Again, it is estimated that Canadian companies with listed stocks report income equal to 38 per cent of the total income reported by all Canadian corporations, while all listed United States companies account for an estimated 47 per cent of the income of all United States corporations, the major reason for this difference apparently being that a number of the largest Canadian corporations do not have stocks outstanding that are listed on Canadian exchanges. The same inferences can be drawn by considering the relative importance to the Toronto Stock Exchange and the New York Stock Exchange, respectively, of each country's top 100 corporations - bearing in mind that both of these exchanges have 90 per cent or more of the market value of all listed issues of their domestic corporations. The top 100 corporations on the Toronto Stock Exchange make up, in market value, 81 per cent of all the Canadian stocks listed on that exchange, while on the New York Stock Exchange

the leading 100 companies form only 60 per cent of the total market value of all New York listed stocks. The greater concentration for Canada than the United States can reasonably be attributed to the greater prevalence in Canada of private - and predominantly foreign-owned - companies.

18. A case in point is General Motors. Although General Motors of Canada is one of the largest companies in Canada, its shares are not publicly traded in Canada. It is, rather, the wholly-owned subsidiary of a United States corporation that is publicly traded in the latter country; in the United States, indeed, there are very few large corporations whose shares are not publicly traded. If a Canadian investor wishes to participate in the equity financing of the Canadian operation of General Motors, he can only do so by acquiring shares in the non-resident parent corporation - and <u>these</u> are listed on the Toronto Stock Exchange. While such an investment may be in the investor's interest - since participation in the more broadly-based and diversified profits of the parent corporation can give more security - the choice does not exist, and the Canadian capital market is correspondingly constricted. General Motors of Canada is but one example of many Canadian companies in similar circumstances.

19. The prevalence of the private company suggests that there is a shortage of Canadian equities in overall quantitative terms. The recent Canadian swing to United States equities suggests only that there is a shortage of Canadian growth stocks. But the latter phenomenon can also be attributed to the prevalence of the wholly foreign-owned private company. As noted above, the American "glamour" stocks, as defined by the preferences of American financial institutions and the behaviour of Canadian mutual funds, are in just those activities where few if any Canadian stocks are available. This, in turn, results because those American companies whose stocks are most attractive and which have a Canadian subsidiary typically wholly own the subsidiary. The most important case in point in this respect is I.B.M., one of the large United States corporations with a wholly-owned Canadian subsidiary. At the end of 1966, Canadian mutual funds held $57 million in I.B.M. stock, out of a total of $660 million in foreign (virtually all United States) stocks; holdings of I.B.M. were not only by far the largest holding for any foreign stock, but were also larger than for any Canadian stock. Similarly, total pension fund holdings of I.B.M. shares in 1966

are estimated to have been $25 million, which was about 9 per cent of the total holdings of these funds in United States common stock.

20. Projections of the future Canadian demand for equities (at current prices) indicate that these shortages are likely to become intensified unless some action is taken. The increase in demand for stocks by the mutual funds and the pension funds has been estimated to be nearly $5 billion over the period 1967 to 1970. If it is assumed that the repatriation of Canadian stocks from abroad returns to its 1961-65 average level and that new issues continue at the recent pace, there will be a shortfall in supply of about $600 million a year. An attempt has also been made to project the holdings of <u>Canadian</u> equities by the mutual funds, the pension funds and the life insurance companies in 1975 by estimating the portion of their portfolio which they will wish to hold in Canadian stocks. It suggests that over the next eight years these three major financial institutions will want to acquire more than $6 billion of Canadian stocks. Thus, these institutions, whose holdings of Canadian stocks at the end of 1966 had an estimated market value of $3 billion and had increased by an annual average of about $300 million since 1960, would be

acquiring an average of $800 million of Canadian stocks each year. In addition, the growing level of personal incomes in Canada can be expected to stimulate a continued demand for stocks by Canadian individuals.

21. If the prospective demand for equities by Canadian financial institutions and individuals is to be met, there must either be a substantial flow of new stock issues from companies presently in existence, that is, companies that primarily are now privately held, or else there must be access to United States stocks. There can be no question that there will be a substantial demand for stocks. The only question is whether these equity-destined funds are to be invested in Canadian stocks or foreign stocks.

22. Given the growing Canadian demand for equities, it will be more attractive for firms to finance in Canada by equity issues. It might be expected that there will be, for market reasons, some induced increase in supply of Canadian equities to match part of the rising demand. Furthermore, United States' restrictions on capital outflows for balance of payments reasons might be expected to encourage local financing by American-owned

subsidiaries, including equity financing when interest rates are high and there is local demand for equities. To some extent, then, market forces and American policies should result in some induced increase in supply in the face of rising demand. To that extent, Canadian policy to deal with the shortage of Canadian equities will be unnecessary. Put differently, Canadian policy to correct this shortage will be able to operate in a context where market forces and American policy are already tending to alleviate the shortage to some extent.

23. The selling of shares by companies presently in existence will not simply divert equity capital from Canadian enterprises, but rather will divert it, to some extent, from investment in foreign stocks; also, there will be some diversion from fixed income investments. The three chief financial institutions involved - the mutual funds, the pension funds, and the life insurance companies - tend to concentrate their stockholdings in the larger Canadian companies; the mutual funds have nearly 80 per cent of their Canadian common stock holdings in the 101 largest listed Canadian companies, the pension funds 93 per cent of their Canadian stock portfolio in these companies, and the life insurance companies over 95 per cent of their

Canadian stockholdings therein. To the extent that these institutions are not investing in large listed Canadian companies, they appear to be investing in a similar kind of company in the United States. Hence, it would seem that new stock issues by companies that are presently privately held would not divert funds from new Canadian corporations but rather would divert funds that would otherwise go into the United States stock market. Furthermore, the institutional holdings in a number of corporations have, in the aggregate, reached major proportions, raising questions as to the willingness of these institutions to make further commitments in these companies. If the institutions wish to continue to invest primarily in large well-established corporations, their ability to greatly expand their Canadian stock portfolio is somewhat limited. More stock issues by established companies would be required, or else a substantial flow of funds would be diverted into American stocks. Also if institutions do eventually diversify more of their portfolios into smaller and newer companies, then if their stock investments flow abroad, so may some of the diversification and newer and smaller Canadian companies would be the losers.

24. Allowance must be made for the possibility that foreign-owned firms which issue shares in Canada may pay the proceeds to the parent. To the extent this happens, the diversion from investment in foreign stocks just discussed will be offset by a new outflow of capital from Canada; in that event, what would happen would be that Canadians would end up with minority holdings in Canadian (foreign-controlled) corporations rather than foreign corporations with no effect on the capital account of the balance of payments. Present United States balance of payments policy would, in fact, encourage American parents to repatriate the proceeds. Also, such payments have occurred in connection with the proceeds of share issues under Canada's 1963 legislation to encourage Canadian ownership. From the Canadian viewpoint, if share issue by foreign subsidiaries is desired, then repatriation of some part of the proceeds is to be expected, and what is relevant is that the Canadian balance of payments be sufficiently healthy to cope with this possibility. At the same time, foreign-owned subsidiaries, like other firms, tend to grow and to need finance to do so. Issuing shares in Canada would be a means to finance that growth and to that extent repatriation would not occur.

25. Of the possible policy inferences of this line of reasoning, the most attractive would appear to be the offering of incentives to the larger (assets of $25 million or more) private companies to make equity shares available. It appears to be superior to a possible alternative of restricting the access of Canadian investors to the United States market. The latter approach would presumably lead Canadian investors to invest more of their assets in Canadian issues, although part of this increase would reflect the higher Canadian share prices that would be expected to result from such a step. Furthermore, a model for such a policy exists, the United States Interest Equalization Tax; imposed for balance of payments reasons in 1963, it has since become an entrenched part of American economic policy. Nevertheless, such a policy would not meet what appears to be the real difficulty, which is the great shortage in Canada of the kind of equities which currently attract North American investors. (Also, whereas the United States balance of payments is in difficulty, which was the rationale for the policy, the Canadian balance of payments is not, as was seen above, in spite of the capital outflow to the United States).

26. The policy alternative of encouraging Canadian equity participation can also be supported on the grounds that it broadens the range of choice of the Canadian investor without virtually compelling him to buy Canadian shares and encourages the Canadian company to issue shares without compelling it to do so. Canadian investors with a strong preference for American stock can continue to satisfy that preference. It should be expected that some at least would do so, for no feasible set of incentives are likely to provide Canadian buyers with the range of investment opportunities present in the United States or to force Canadians completely out of that market.

27. But there is reason to believe that Canadians in general and Canadian financial institutions in particular would be prepared to hold more Canadian stocks. Of the 101 share issues of the largest Canadian corporations for which complete data is available, 89 issues have shown an increasing proportion of Canadian ownership in the period since 1962. For the 10 companies that have made public for a number of years a breakdown of their shareholders between residents and non-residents, the proportion of Canadian ownership has either remained steady or has increased.

28. Multi-national firms with a strong preference for not issuing shares of their Canadian subsidiaries can continue to satisfy that preference, albeit at some cost. It should be expected that some at least would do so, for the commitment of some firms to the wholly-owned subsidiary is too strong to be shaken by any feasible set of incentives.

29. This policy alternative, in the form presented here, permits of minority participation, but the minority shareholders need not be Canadians. Specifically, the larger companies would be encouraged to offer fully participating and voting common shares to the public. This proposal, by not requiring that Canadians hold the shares, has the advantage that foreign purchasers would constitute a safety-valve from the viewpoint of the capital market against excessive supply and demand pressures. This specific policy alternative has the drawback, however, compared to encouraging <u>Canadian</u> ownership, that it can lead to foreign minority shareholding rather than Canadian minority shareholding. In terms of obtaining disclosure - which would be an important benefit (see above, <u>Performance of Firms</u>) - this does not matter. But in terms of ensuring a Canadian presence, financial and otherwise, it does

matter. Minority participation may be obtained at the cost of creating some disincentive for the foreign parent to push the growth of the Canadian subsidiary, since profits earned in Canada will have to be shared with minority shareholders and decisions will have to take them into account. Where the minority owners are foreigners, the benefits of a Canadian presence are not obtained.

30. If it is Canadians who buy the shares, to the extent this is not done at the expense of Canadian purchases of American shares, or at the expense of Canadian purchases of fixed-income securities, the Canadian presence is bought at the cost of foregoing superior growth-inducing alternative uses of these funds. As noted earlier, the cost of a 25 per cent minority issue in all corporations with assets of $25 million or more would be $3.5 billion to $4.5 billion at a minimum. Furthermore, some portion of the proceeds of share issue is likely to be repatriated by the parent, particularly given the present nature of American balance of payments policy. Insofar as the Canadian balance of payments position is a strong one, particularly compared to the American, some repatriation is tolerable, however, and will reduce the long-run drain of dividend payments abroad.

31. This policy alternative in the form assumed here encourages <u>all large</u> Canadian private companies, without respect to ownership, to go public; hence, it does not discriminate against foreign firms and does not work a hardship against smaller firms. Finally, a policy of encouraging corporations to issue shares to the public is most likely to be effected through tax incentives; a calculation of the net benefit of such a policy would have to allow for the tax revenue foregone.

32. As has been noted before, there are a range of potential benefits and costs to Canadian equity participation, transcending simply capital market considerations. The important point for present purposes is that capital market considerations <u>per se</u>, namely, the present and very probably increasing shortage of Canadian equity securities, do support measures to encourage the issue of equity stocks in Canadian corporations.

Conclusion

33. The two implications for policy developed in this section - the creation of the Canada Development Corporation to play an entrepreneurial role and to provide an additional vehicle for the investment of Canadian savings, and the granting of incentives to firms to encourage the issue of common shares - are interrelated. They constitute alternative, and possibly competing, uses of Canadian capital. To the extent that they are designed to meet different needs, however - the former a shortage of "entrepreneurial capital" and the latter a shortage of stocks in established companies in certain industries - both are necessary. Each adds a distinct dimension to the range of choice of the Canadian investor; the market could then determine which was preferred by Canadians as an outlet for their savings.

vii. Politics of Private Foreign Investment

1. The free movement of goods, technology and capital across national boundaries is the hallmark of a new level of economic interdependence in the modern world and carries the promise of substantial economic benefits for participating countries. Canada neither can nor should refrain from playing a greater part in this growth of the international economy. Economic interdependence, however, in its day-to-day operations, opens new channels of contact and exposes national economies to foreign influence and foreign administrative controls. These contacts and controls occur between governments, between parent and subsidiary, and between each government and the parent and subsidiary respectively. Closer ties and their accompanying constraints pose the basic dilemma for independent policy-making for those countries such as Canada with a high level of foreign investment.

2. Analysis of the political implications of foreign investment is peculiarly liable to founder on semantics. To some, the politics of private foreign investment will conjure up only long-standing problems in regard to the legal sovereignty of each of

the states involved; within that group, there will be some who will insist that any political costs for the host country can only be attributed to the spinelessness of its policy-makers. To others, the political issue will smack of exploitation of small countries by big companies. To many, politics of any kind means neither more nor less than the day-to-day uproar in the mass media and the dramatic cases of confrontation of competing power groups. To a few, even to speak of the politics of <u>private</u> foreign investment may seem absurd.

3. It must be recognized that this aspect of foreign ownership is controversial and there is a paucity of research, official and private. It is suggested that politics, as the exercise of power, be thought of in two ways. There is, first, the formal legal process as such - the question of power to make laws. Canada undoubtedly has sovereignty in this respect, subject to a qualification to be considered below on the extraterritorial extension of United States law into Canada.

4. But of equal importance is the capacity to implement decisions in the public interest, a capacity which reflects the degree of national

independence as distinct from sovereignty _per se_. Private decision-making by large corporations, among other private bodies, clearly affects the capacity to implement public policies even in a closed economy. Where part of the decision-making is done outside the country as is the case with foreign direct investment, there is a special significance attached.

5. In the nature of the case, there is a strong presumption that foreign ownership, because of its effects on the locus of private decision-making, reduces national independence. But it should be recognized that both constraints as well as opportunities are involved. What foreign ownership does is open up new channels of communication and influence, public and private, along which power flows. These channels run, at least in principle, both ways. The host country may gain the capacity to exercise power both on the foreign subsidiary as well as on the foreign government but may be in turn subjected to external power by both of these entities. Thus foreign ownership may increase national independence along some dimensions as it decreases it along others. To the extent that parent firms or their governments effectively run the multi-national firm to suit the private and public

interests of the foreign state, then the national independence of the host country is threatened. To the extent that the government of the host country can effectively apply policy that makes foreign firms behave like "good corporate citizens" it can increase the benefits and decrease the costs from foreign ownership and limit the erosion of national independence that results from the absence of policy.

6. The public unease which has accompanied the high level of foreign control in Canada results from the potential shift of decision-making power outside of Canada. The extent of this shift and its significance for Canada, are the issues that merit empirical examination. That examination involves the consideration of a number of interrelated variables:

- the overall level of foreign ownership in Canada, and its distribution: by country of origin, particularly vis-a-vis the United States; by regions within Canada; by sectors and industries; by size of firms, particularly of large firms.

- the extent to which the countries of origin, particularly the United States, insist on the primacy of their jurisdiction, and, in general, insist that Canadian subsidiaries are proper instruments for the exercise of their policies.

- the effects on independent Canadian policy-making of the presence of foreign ownership, including both the constraints imposed and the opportunities created.

- the extent to which officers of the subsidiaries have power to make decisions in Canada and to which foreign subsidiaries allow Canadians to participate as directors, managers and stockholders.

Level and Distribution of Foreign Investment

7. The overall level of foreign ownership in Canada is significantly higher than that for any other economically developed country and higher than for most of the underdeveloped countries. At the end of 1963, non-resident ownership in manufacturing, petroleum and natural gas, mining and smelting, railways, other utilities and merchandising - that is, most of the economy excepting agriculture and service industries - totalled 35 per cent and the corresponding figure for non-resident control was 34 per cent. Corresponding figures for Australia, Western Europe, and Japan - all of which are highly developed areas to which foreign direct investment has flowed in the past - are substantially lower than for Canada. (The United States has by far the largest stake in direct investment, and in 1965 its direct investment of $29.22 billion was distributed as follows: Canada $15.17 billion, Latin America $9.37 billion, other Western Hemisphere $1.44 billion, Europe $13.89 billion, Africa $1.90 billion, Asia $3.61 billion, Oceania $1.81 billion, and international and unallocated $2.02 billion.) Insofar as both benefits and costs inhere in foreign direct

investment, Canada has been the recipient of both to a unique degree. Insofar as foreign ownership risks decreasing national independence, Canada is uniquely susceptible.

8. Foreign investment in Canada comes overwhelmingly from the United States. The total book value of non-resident owned direct investments in Canada at the end of 1964 was $15,889 million, of which $12,901 million was owned by residents of the United States, $1,944 million by residents of the United Kingdom and $1,044 million by residents of other countries. At the end of 1963 United States-resident ownership in manufacturing, petroleum and natural gas, mining and smelting, railways, other utilities and merchandising totalled 28 per cent and the corresponding figure for United States-resident control was 27 per cent. About four-fifths of foreign ownership and control, then, is accounted for by the United States. Australia, which appears to be second to Canada among developed countries in the extent of foreign ownership and control - though significantly below Canada - has its foreign investment divided between the United States and the United Kingdom.

9. Other things being equal, for any overall level of foreign ownership, the potential threat to independent policy-making is greater the greater the extent to which foreign ownership is concentrated in a single country, particularly when that single country is the most powerful political entity in the world. The political consequences would be less onerous if foreign ownership was widely scattered among different countries or if it was concentrated in a less politically powerful country. Canada is closely integrated with the United States in many ways other than foreign ownership, but foreign ownership is one of the most important of these ties. It contributes as well to other links, such as the concentration of trade with the United States and the prevalence of American brand names. American investment has contributed substantially to the economic integration of the Canadian and American economies with its attendant economic advantages as well as potential political liabilities.

10. Whether, in fact, the potential threat to independent policy-making in the host country is realized, depends on the use by the government of

the foreign country of the parent-subsidiary relation as an instrument of its foreign policy, and also on the vigilance of the host country's government in preserving its power over firms resident in its domain. The fact that Canada and the United States enjoy unusually friendly relations, both by treaty and informally, and that the United States government has asserted its "right" to extraterritorial jurisdiction only in certain areas, does not invalidate the principle involved. Canadian private and public relations are so intertwined on so many fronts with one large country that constant attention by the Canadian government is necessary if the degree of independence possible in an open economy is to be maximized.

11. The regional impact within Canada is also relevant to the politics of private foreign investment, since it may complicate the formulation of national policy. The desire of each province to get as much job-creating investment, including foreign direct investment, as it can has created a tendency toward minimal constraints on, and maximum encouragement of, foreign ownership. It is clear that no policy toward foreign investment can be effective unless it is a national policy which,

by its nature, transcends a strictly regional perspective. There is reason to believe that regional loyalties and aspirations do not rule out a national policy toward foreign investment. Public opinion polls show that significant numbers of Canadians, from all provinces, are concerned about the effects of foreign ownership on national independence. It can be inferred that new national policies toward foreign ownership which recognized regional aspirations for economic growth and respected the constitutional rights of the provinces would receive support throughout Canada.

12. While the foreign, and particularly American, ownership of Canadian economic activity varies by sectors and industries, it is widespread throughout the primary and secondary manufacturing industries. The pervasiveness of American ownership means a multiplicity of corporate links which tie the Canadian industrial structure into the American industrial structure. It is sometimes said that, in the nature of market economies, each of these links is separate unto itself, that they are not additive, and that Canada does not face a monolithic American owner. This view undoubtedly has some merit, and is accepted by many Canadians.

13. Recent developments in the American economy, however, suggest that another view must be given consideration, namely, that American corporations and the American government - and trade unions and universities as well - are being bound into what is variously called the "new industrial state", the "technostructure", or the "industrial-military complex". In this view, distinctions between the private and public sectors, and between private and public decisions, are increasingly blurred, and the emphasis on the decentralized and competitive character of the American economy is replaced by an emphasis on its increasingly centralized and interdependent character. It would follow that American ownership of Canadian industry has risked the absorption directly or indirectly of part of the Canadian economy into the American technostructure.

14. To the extent that this view has relevance, political implications of a fundamental nature flow from it. While American subsidiaries operating in Canada are, in one sense, simply Canadian firms owned by individual American corporations subject to Canadian law and policy, they are also parts of the American industrial state influenced by, if not directly subject to, American law and policy

formulated in the pursuit of American objectives. Insofar as the latter transcend economic objectives to include the objectives of foreign policy and national security, it can be argued that Canadian subsidiaries become, at least indirectly, instruments of American foreign policy and American military goals. There is, in fact, substantial identity of interest in Canadian and American foreign policy objectives. Nevertheless, there is a difference between voluntarily travelling a parallel route at a time when our objectives have much in common, and having United States policy implemented through pressure on subsidiaries resident in Canada, even when our objectives diverge as, for example, in foreign trade.

15. While foreign ownership is pervasive in Canada, there are certain key sectors, notably communications and financial institutions, where its penetration is negligible or limited. This is due in large part to Canadian policy, the rationale for which is fundamentally political. Sectors appear to be designated "key sectors" because they are believed to constitute the "commanding heights" of decision-making, in the sense that the decisions made therein ramify widely throughout the economy (as with banking),

or that the sector is quasi-public because of its importance in implementing government policy (as with monetary policy implemented through the banking system), or that the activities of the sector pervasively influence public opinion and hence the environment within which decision-making takes place (as with the media of communication). The means for excluding or limiting foreign ownership and control may be by legislation or by public ownership, which are explicitly political techniques, as in the case of Crown corporations such as the Canadian Broadcasting Corporation.

16. There has been some tendency outside Canada, notably in France, to regard industries which are in the vanguard of scientific-technological change and which appear to have widespread implications for the economy and for military purposes such as the computer industry, as being key sectors where the dominance of foreign firms must be countered by deliberate attempts to build up domestic competition. The explicit formulation of criteria of this nature may be necessary if the key sector concept is to have future application.

17. Foreign ownership in Canadian industry is substantially embodied in large firms with market power. Many foreign-controlled firms in Canada

are oligopolists and many oligopolistic firms in Canada are foreign-controlled. (See above, Structure of Industry.) It is unnecessary to appeal to arguments about the technostructure of the new industrial state to see that these facts have political implications. Significant decision-making power is centered in the hands of large corporate institutions. Public significance inevitably attaches to their decisions. In principle, in an economy of small competitive firms, the power of decision of any one firm would be strictly limited. The rule of market forces would impose its discipline. But the modern economy is one where corporations have significant autonomy in decision-making. While foreign ownership is not as relevant to the performance of firms as is sometimes alleged in Canada, it is not entirely without significance. This is particularly so with respect to Canadian participation as directors, senior managers and investors and, for American-controlled firms, with respect to vulnerability to American law and policy.

18. There is an important implication for national policy in this line of reasoning. On the one hand, in the absence of perfect

competition and the full reign of the market, firms have some freedom to determine their own varied objectives. On the other hand, because they are not fully disciplined, and constrained, by market forces as in a fully competitive economy, they can afford to be more susceptible to government policies. Hence, the Canadian guiding principles, by relying on persuasion to change the performance of foreign-owned firms, implicitly recognize that the latter are typically oligopolists with some discretionary power in their hands to accede to these principles. But various American laws and policy directives applied to subsidiaries of American corporations also have substantial influence. The inference for Canadian national policy is that a strong government presence is needed to countervail both foreign private economic power and foreign government power.

Extraterritoriality

19. The most apparent political cost for the host country of foreign ownership results from extraterritoriality. The term refers to the intrusion of the jurisdiction of one country into another, or the subjection of residents of one country to the laws and policies of another country. The direct investment subsidiary, being resident in one country and owned and controlled by residents of another, becomes a vehicle through which extraterritoriality can be exercised. While this might conceivably run both ways, with the host country subjecting the parent of the subsidiary to its laws rather than just the subsidiary, both laws of property and the tendency for host countries to be smaller than countries of origin, in practice make the channel run one way, from the country of origin to the host country.

20. Hence, the issue of extraterritoriality in Canada is almost inherently one of asymmetry that works against the host country. From the perspective of the host country, if the country of origin insists on the primacy of its jurisdiction and regards subsidiaries as proper instruments for the exercise of its policies, economic and otherwise, problems

are created that are too serious to be ignored and often too intractable to be fully resolved, short of outlawing foreign ownership.

21. In one sense, what happens is that the question of "what is the nationality of the multi-national firm?" is thrown into stark relief. If, as often appears to be the case genuine multi-nationality is absent, this is bound to undermine host country policy toward foreign owners premised on genuine multi-nationality, that is, obedience of the subsidiary to local law and local policy, regardless of directives from the parent or from its home government. The successful intrusion of foreign law constitutes a direct erosion of the sovereignty of the host country insofar as the legal capacity of the latter to make decisions is challenged or suspended. Insofar as subsidiaries become instruments of policy of the home country rather than the host country, the capacity of the latter to effect decisions, i.e. its political independence, is directly reduced.

22. The position of the subsidiary is likely to be one of discomfort; expected to meet standards of good corporate behaviour in the host country, it finds itself subjected to overlapping or divergent

legal constraints locally and from abroad which preclude its doing so. Confronted with two peaks of sovereignty, it is likely to defer to the higher peak on which its foreign owners reside. The position of the parent is more ambiguous. As a corporation pursuing profit and growth in an international context, it might be expected that it would be willing to let its subsidiary comply with local jurisdiction if possible. At the same time, however, its directors and managers, as citizens of the home country will be subject to its laws and will largely share the objectives of the latter, particularly in matters of national defence and foreign policy where the exercise of extraterritoriality is most likely to occur.

23. Canadian concern about the exercise of extraterritoriality by foreign governments through the instrumentality of the subsidiary resident in Canada has manifested itself in the specific contexts of United States laws on the control of exports, United States anti-trust law and policy, and United States balance of payments policy. These issues involve, in part, the actual intrusion of American law into Canada and are unquestionably examples of extraterritoriality proper which directly limits

Canadian sovereignty. All three also encompass "voluntary compliance", namely, informal directives sent by the American government to the parent companies. These informal policy directives do not, threaten Canadian legal sovereignty, but, to the extent subsidiaries alter their behaviour to conform with American objectives rather than Canadian objectives, Canada's political independence is threatened.

24. An elaborated set of laws, regulations, and administrative procedures exists in the United States for the purpose of controlling all trade with Communist countries. Their purpose is to give effect to American foreign policy on trade with Communist countries which is, broadly, that such trade should be directly based on considerations of American national security and American overall foreign policy objectives. Their scope extends to activities going well beyond those which result from American ownership and control of foreign firms, but specifically include the latter.

25. Under the authority of the Export Control Act of 1949, the Office of Export Control of the United States Department of Commerce has the power to prohibit the export from the United States of all commodities and all technical data unless

a general license granting such permission has been established or a specific ("validated") license has been issued by the Office of Export Control. Foreign countries, as potential importers, are classified into country groups, each subject to differing degrees of control. The country classification is such that Communist countries face the severest controls. The issue of extraterritoriality arises insofar as the regulations issued under the authority of the Act apply as well to re-exports from third countries and encompass all goods containing American components and American technical data. The Export Control Regulations are expressly applicable to any person within or without the United States. While non-Americans are thus liable to criminal penalties, the effective sanction under the Act is denial of opportunity to participate in United States export transactions by official "black listing"; to be cut off from United States exports would be, for many foreign firms, a severe blow.

26. Canada enjoys a special position under these regulations, though for a price. Canada alone is exempted from the country classification cited above.

The United States allows the practically unregulated export of nearly all United States-origin commodities and technology, provided that Canada remains the final destination of consumption or use. Canada, in return, does not allow United States controls over known United States-origin goods to be frustrated by shipment and diversion through Canada. The Canadian government too regulates Canadian export trade under the authority of the Export and Import Permits Act. Originally intended largely as a means to implement NATO controls on the movement of strategic commodities to Soviet Bloc countries, it has also become a means by which Canada, in return for the open border, assists in the enforcement of United States controls on trade with Communist countries in non-strategic commodities. Hence, Canadian export permits are needed for re-exportation of goods originating outside of Canada, which in most cases means the United States.

27. To the extent Canada relies on imports of United States components and United States technology, Canada's export trade becomes subject to United States decrees intended to give effect to United States foreign policy. The relevance of this discussion to foreign ownership arises insofar

as American ownership of Canadian industry tends to increase Canadian reliance on American components and technical data.

28. Canadian foreign policy on trade with Communist countries is broadly that, ideological differences notwithstanding, it is desirable to have trading relations with these countries in non-strategic goods, and that such trade should be allowed to develop without too many impediments. Thus, when the Canadian authorities aid in the enforcement of United States law they are giving effect to United States foreign policy objectives that are not identical to Canadian foreign policy objectives. Nevertheless, given the pervasive trade ties between Canada and the United States and the extent to which Canada could therefore be used, from the viewpoint of American authorities, to undermine the effectiveness of American policy, the Canadian bargain for the open border can be defended as a necessary one. At the same time, however, these realities must not preclude Canadian policy-makers from constantly bearing in mind that Canadian foreign policy in these matters is different from American foreign policy and that the former must be given precedence wherever possible. American ownership of Canadian

industry tends to increase the extent to which Canadian authorities become the instrumentalities of American authorities.

29. The issue of American ownership of Canadian industry arises more directly under the United States' Trading With the Enemy Act of 1917 which regulates all commercial and financial transactions by Americans with foreigners. Under a declared state of emergency that has existed since 1950, Foreign Assets Control Regulations are presently applied through licensing by the Office of Foreign Assets Control of the United States Treasury with respect to trade with Communist China, North Korea and North Vietnam. Cuban Assets Control Regulations govern transactions with Cuba.

30. These regulations specifically include foreign affiliates and subsidiaries of United States persons or firms, where Americans have actual or potential effective control. Thus, whether a majority of the directors are or are not American citizens, when 50 per cent of the stock of a foreign company is United States-owned, all Americans involved as stockholders or directors are liable for the company's violations of the Treasury Regulations. Specifically, the Foreign Assets Control Regulations, apply to the exports

of United States subsidiaries even if the commodities make no use of American components or technology. When the Office of Foreign Assets Control is faced with a possible infringement of its Regulations by a subsidiary, the American parent is notified that its subsidiary has entered into an export transaction for which the parent - that is, its directors and shareholders - is criminally liable under the Foreign Assets Control Regulations. The parent is then expected to instruct its subsidiary to withdraw from the transaction.

31. The Cuban Assets Control Regulations are similar in substance except that a general license provides for a narrow exemption from the broad prohibition: foreign companies owned or controlled by Americans may trade with Cuba in foreign-origin goods provided that United States dollars and United States-owned or controlled transport are not involved, and that affiliated United States persons or companies do not in any way participate. This concession seems largely illusory, however, for the United States authorities have called for voluntary compliance by American firms in not having their foreign affiliates trade with Cuba and appear generally to have secured that compliance. In effect, informal

administrative techniques, rather than formal criminal sanctions, may be sufficient, in this and other respects, to get parent companies to direct their subsidiaries to comply with American foreign policy objectives.

32. Canadian policy on trade with Communist countries is significantly more liberal than American policy. Canada occupies no special position under these assets control regulations, but is substantially subject to them because of the unusually high level of American ownership and control. There are, in fact, a number of cases on record where American subsidiaries have declined to fill orders because of the Trading With the Enemy Act. In the nature of the situation - namely, the possibility that a subsidiary would simply show disinterest in any approach that might be made with respect to exporting to these countries, and the preference of both the Canadian and American governments to try to resolve differences through quiet diplomacy - it is impossible to determine reliably how important these regulations are in deterring Canadian trade. It is known that certain cases which have come to the attention of the Canadian public have created

significant dissatisfaction in Canada. Both governments have made some attempt to work out a modus vivendi.

33. The Eisenhower-Diefenbaker Joint Statement on Export Policies of July 9, 1958, recognized that the export policies and laws of the two countries may not be in complete harmony and called for "full consultation between the two governments with a view to finding through appropriate procedures satisfactory solutions to concrete problems as they arise." Such formal consultation takes place annually on these and other matters at the ministerial level. Specific concessions have been made by the American authorities to the extent that they will permit a possible exemption for their subsidiaries on a case by case basis when it can be shown that a firm order for a prohibited good from a Communist country cannot be filled by a comparable Canadian company and that the particular order is of importance to the Canadian economy.

34. Though this procedure is not without merit, it has three important limitations from the Canadian point of view. First, the United States reserves its right to impose its prohibitions upon the

parents of American-owned firms. Consultation takes place within that constraint. Canadian authorities are put in the position of tacitly accepting the principle of extraterritoriality when they enter such consultations for exemption. Second, it is impossible for anyone to know how many export orders might have been filled in Canada in the absence of these regulations. No procedure exists by which it is known whether firms resist approaches for possible export orders, or even whether bona fide orders are being filled; no estimate can be made of economic losses to Canada by virtue of trade opportunities foregone by American subsidiaries. Furthermore, reliance on quiet diplomacy while marginally softening the American position, means that the Canadian public does not have available to it full information on the cases involved, though it is clear from the response to the few publicized cases that there is widespread interest and concern. Third, confronted with an elaborate American legal and administrative apparatus, Canada possesses no analogous countervailing instruments. The Canadian "hand" is substantially devoid of any cards but that of the long tradition of goodwill brought to these negotiations.

35. There can be no doubt from the Canadian point of view that the best solution to this problem would be for the United States to cease to extend its export regulations extraterritorially. Indeed, pursuant to the meeting of President Johnson and Prime Minister Pearson of January 1964, the Merchant-Heeney Report, "Canada and the United States, Principles for Partnership" was issued in June 1965. It recommended this ideal solution, namely, that American subsidiaries in Canada be granted a general exemption from the administration of foreign assets control regulations under the Trading With the Enemy Act. This recommendation has not been implemented and seems at present to be a dead letter.

36. In the light of this situation, second-best solutions are the only ones available. One possibility is for Canada to take an international initiative, as through the United Nations, to have member countries renounce extraterritoriality. The advantage of such an approach is that it could pave the way for international solutions to a range of issues surrounding the multi-national firm, the question of its legal nationality being simply the most basic. The drawback is that few other countries have sufficient American direct investment to share

fully Canada's concern, while the viability of this solution ultimately depends, again, on the willingness of the United States to cease viewing American subsidiaries as creatures of American law and instruments of American policy. There would appear to be no feasible alternative but to initiate a national policy in Canada.

37. The broad strategy of such a national policy could be three-fold: provide legal and administrative backing to support Canadian interests in the regular context of consultation and negotiation; while creating no new departures in principle, institutionalize the existing Eisenhower-Diefenbaker Agreement and the ground rules that have evolved from it; and undertake a program of research and policy planning to appraise potential costs of withdrawal of special American concessions and map out alternative strategies of economic development.

38. Specifically, a government export trade agency might be created with the necessary powers to ensure that export orders are filled when they conform with Canadian law and Canadian foreign policy. State trading organizations of Communist countries could register orders placed with

Canadian firms with the agency. Where an American subsidiary refused a <u>bona fide</u> order placed with it, the agency could endeavour to have the order placed with a Canadian-owned firm, where this was possible. Where no Canadian-owned company could fill the order, the reluctant American subsidiary should show cause to the agency. If the sole inhibition is judged to be American foreign assets control regulations, the agency could purchase the item on its account for resale to the state trading organization, with supporting legislation making it a criminal offense for a firm to refuse to sell to the agency at existing market prices.

39. This action by the Canadian government would do no more than institutionalize and enforce the existing practices of the Eisenhower-Diefenbaker agreement while shifting the initiative to the Canadian side. American directors and shareholders of the parent company would likely be exempt from prosecution since they could deny that they had the requisite intent to violate Treasury Regulations. The full procedures would be applied only after the <u>bona fide</u> nature of the order was firmly established and alternative means of filling it within Canada had been exhausted; hence, there would be no intent to create avoidable problems for American subsidiaries.

40. A very significant byproduct of the agency would be the availability of full information to the Canadian government of export possibilities that may be going by default. Also, the agency could conduct its affairs in such a way as to keep the public fully informed; short of publicity on an on-going basis, cases dealt with by the agency could be reported to the public ex post facto. A second by-product that could result from this agency would be to have it also undertake an active export promotion campaign with state trading agencies of Communist countries coupled with assurances that export orders would be filled.

41. The United States is strongly committed to the view that a free market economy should be maintained by the vigilant application of anti-trust law. This philosophy, moreover, has been extended to the spheres of foreign commerce and the foreign operations of American-based multi-national firms. The Sherman Act, which is the basic law, makes illegal "Every contract, combination ... or conspiracy, in restraint of trade or commerce among the several States, or with foreign markets" and makes it a crime to "monopolize, or attempt to monopolize, or combine or conspire with any other person or

persons, to monopolize any part of the trade or commerce ... <u>with foreign nations</u>" (underlining added). The Act allows for civil proceedings to enforce the Act as well as criminal prosecution, and actions involving extraterritorial issues normally are public-civil proceedings.

42. Section 7 of the Clayton Act concerns mergers between corporations engaged in commerce "where in any line of commerce in any section of the country, the effect may be substantially to lessen competition, or tend to create a monopoly". There is every indication that this section applies to foreign trade, and particularly to United States corporate takeovers of foreign competitors in the domestic American market. Practices deemed injurious to the import trade of the United States are regulated by particular provisions of a number of statutes. The Webb-Pomerene (Export Trade Act) of 1952, however, allows, though under stringent conditions, the forming of associations of exporters for the sole purpose of engaging in export trade. The United States has also made use of Treaties of Friendship, Commerce and Navigation to deter restrictive trade practices abroad, that is, the contracting parties "agree

upon the request of the other ... to consult with respect to any such practices and to take such measures as it deems appropriate with a view to eliminating such harmful effects".

43. The extraterritorial intrusion of United States anti-trust law and policy has, on occasion, met heavy criticism in other countries, including Canada. The Canadian case is unique, however, in having resulted in the only bilateral agreement entered into by the United States specifically aimed at ameliorating tension. Particularly vocal Canadian government criticism of United States prosecution in the Radio Patents Pool case - where the complaint alleged that a Canadian patent pool controlled by the Canadian subsidiaries of American corporations prevented the importation into Canada of radio and television receiving sets manufactured in the United States - resulted in the establishment of an informal agreement termed the "Anti-Trust Notification and Consultation Procedure", or the Fulton-Rogers agreement, "whereby each country, in enforcing its own anti-trust or anti-combines laws, consults the other when it appears that the interests of the other country will be affected by such enforcement". In practice, this means that the United States informs Canada of its proceedings in cases involving Canadian-based companies.

44. The United States courts have asserted a very wide-ranging competence of jurisdiction over foreign defendants. The fact that a United States corporation is a parent corporation will suffice for a jurisdictional hold over foreign affiliates within its control as determined by the courts. It would appear that United States anti-trust laws favour the retention of majority, if not full, ownership by the United States parent corporation in its foreign subsidiaries so as not to excite suspicion of limiting competition between joined owners. The successful prosecution in the Radio Patents Pool case provides cause for United States parent corporations to deny their Canadian subsidiaries the right to make agreements destined to increase manufacturing in Canada at the expense of preventing imports from the United States by non-parties to the patent agreements.

45. The exemptions permitted under the Canadian Combines Investigation Act whereby export associations are allowed in specific instances may be problematic, or even illusory if potential members are controlled by United States enterprises. It is not beyond the realm of possibility that Canadian programmes to rationalize industries

through merger would be suspect in certain circumstances where some of the firms involved were United States-controlled. The purchase by a United States firm of a Canadian-based business that competes in the United States market may attract prosecution. In the Schlitz-Labatt case, a contract providing for the sale of Canadian-held shares in a Canadian company to Americans was set aside by a United States court on the grounds that Labatt's control of a United States competitor of Schlitz would grant the latter an unlawful advantage in the California market. It remains open for similar reasoning to be applied where American take-over of a Canadian concern is viewed as having a detrimental effect on the United States import trade. There appears to be no restriction, however, on the ability of a United States parent to deny the subsidiary access to the United States market - unless the subsidiary was formerly a competitor or unless there is a significant public holding in the subsidiary.

46. The decree of a United States court requiring positive conduct abroad carries with it the possibility that the corporation will be placed in conflict with foreign law. Indeed, this is likely to be so except in two circumstances: where the

foreign law and the United States law are identical, and where the parties are so closely associated, as in a wholly-owned parent-subsidiary relationship, as to render most unlikely the bringing of an action in the foreign jurisdiction to compel adherence to past conduct deemed lawful by that jurisdiction. Where there is a clear conflict of corporate obligations, a "saving clause" can be inserted into the court's order. That is, if there is a showing of difficulty in complying abroad with the decree because of the law of the place of commission, the courts have merely proceeded with the affirmative order coupled with an invitation to the defendant to reappear to present his plea for modification of the decree.

47. While these saving clauses have value in ameliorating conflicting demands from two legal systems, there remains the considerable area of regulatory assertion where conduct outside the United States is ordered to be changed with the court's realization that the violation of United States law is lawful, but not required, in the foreign jurisdiction. Thus, in the Canadian Radio Patents Pool case, compliance with the United States decree caused the withdrawal of the Canadian subsidiaries from the patent pool, though the

condemned activities had been carried on under the protection of Canadian patent law.

48. While tension inheres in extraterritoriality, the situation becomes acute to the extent that United States anti-trust law is particularly stringent relative to the law of the host country. This is certainly the case relative to Canadian anti-combines law, at least as actually applied in the past. Changes in Canadian law and policy in the direction of more vigorous use as suggested above (see Structure of Industry) would reduce tension in practice. Nevertheless, this cannot be regarded as a proper solution to American extraterritoriality. Whether a decree of a United States court does or does not help to maintain competition in Canada - or prevent the American take-over of a large Canadian firm, as in the Schlitz-Labatt case - is irrelevant. Such benefits are bought at the excessive price of lessening Canadian sovereignty and, if deemed desirable, could be achieved directly by Canadian policy without the undesirable political costs. Furthermore, future Canadian anti-combines policy, while encouraging competition should not preclude government-sponsored rationalization in the Canadian

public interest and would, in that respect, diverge from American practice.

49. While American anti-trust policy deserves to be applauded for its serious intentions to maintain competition at a time when American business is extending itself globally, legitimate doubts can be raised as to whether simple imitation of American practice would effectively increase world-wide competition. It is a fact that American corporations presently dominate direct investment globally; other countries are entitled to be reluctant to apply anti-monopoly policy of a type that mignt inhibit the growth of their own firms as effective competitors at home and abroad to American giants which already exist and flourish, American anti-trust law notwithstanding.

50. Canadian policy should be directed toward insisting that Canadian firms not be regarded as instruments of foreign law by taking steps which block the intrusion of such law. In part, this should be done at the international level. The issue of extraterritoriality is one aspect only of the broader problem of devising international policies to maintain competition at the global level

and Canada, as one of the world's leading importers, has a clear interest in the latter. The United States is favourable to multilateral solutions to the monopoly problem and Canada should join in such efforts, insisting however that American extraterritoriality via the parent-subsidiary relationship is, in fact, a manifestation of unilateral action inconsistent with genuine multilateralism. The Fulton-Rogers agreement serves a useful purpose, but solely in the area of lessening tensions in Canada-United States relations, rather than by striking at the source of the difficulty. As in the case of export controls, the ideal solution from the Canadian point of view would be for the United States to so amend its law and alter its practice as to preclude requiring Canadian subsidiaries to obey American law and be responsive to American policy. Since the United States shows no sign of a willingness to do this, "second-best" solutions are in order.

51. There are a number of specific steps which could be taken by the Canadian government that would tend to block the intrusion of American anti-trust law into Canada. First, the government could legislate to prohibit the removal of commercial records and data from business concerns within

federal jurisdiction by reason of a foreign court order. Such legislation already exists in Ontario and Quebec and, in a restricted form, in the United Kingdom. Its effect would be to impede efforts by United States agencies and courts to investigate internal Canadian commercial activities. While it would not reduce the actual extraterritorial effect of the United States court decrees, it would be useful as reflecting a positive stand against United States regulatory intrusion in a way that has sufficient precedent that it should not disturb Canada-United States relations.

52. Second, consideration should be given to means of securing from Canadian subsidiaries of American corporations more information about the operational impact of United States anti-trust legislation. While it is a straightforward matter to trace the effect of American legislation through overt decisions, its impact on the day-to-day managerial direction of United States affiliates in Canada is impossible to assess. It is not known, for example, how the extraterritorial application of these laws affects decisions by subsidiaries whether to seek Canadian equity capital, whether to participate in certain export markets, or whether to cooperate with a competitor of the parent corporation where such cooperation is permitted by

Canadian law. The relevant questions could be included in the more detailed guiding principles questionnaire suggested above (see Performance of Firms); indeed, such questions are an example of the type which need to be included if the guiding principles are to deal with identifiable issues arising from foreign ownership *per se* and are to be made operational.

53. A third pertinent measure is the enactment of legislation to prohibit Canadian compliance with foreign anti-trust orders, decrees or judgments. Among western nations, the Netherlands already has such legislation. The Netherlands Economic Competition Act of 1956 forbids compliance "... with any measure or decisions taken by any other State, which relate to any regulations of competition, dominant positions or conduct restricting competition" without the approval of the Netherlands government. Such legislation is hardly a complete solution, for it can be circumvented by the United States concentrating its sanctions on the American parent company. Nevertheless, by explicitly creating the prospect of conflicting legal obligations, it might deter American courts in the extension of their fiat abroad. In the absence of United States concessions to the Canadian viewpoint, and in the long period before international

solutions to extraterritoriality are likely to be affected, it is desirable for Canada to take all steps within its power to protect its sovereignty.

54. In recent years, the United States has encountered recurring balance of payments difficulties, and has attempted to meet these in part by guidelines to parent firms suggesting changes in the behaviour of foreign subsidiaries that would bolster the American balance of payments. To the extent that the voluntary guidelines on payments by the subsidiaries to the parent became mandatory controls in January 1968 (see above, <u>Balance of Payments</u>), Canadian independence is diminished by this American exercise in extraterritoriality. The inference is created that American-controlled subsidiaries in Canada are part of an American corporation rather than a genuinely multi-national corporation. Canadian public control over such subsidiaries is, by implication, challenged. Even when the system was wholly voluntary, an administrative apparatus existed for surveillance of the behaviour of the corporations. As the balance of payments of the United States has worsened, voluntary guidelines are becoming mandatory controls and machinery for surveillance, machinery for regulation and control.

55. Canadian objections have been made to United States policy in this regard. A statement issued by the Canada-United States Joint Committee on Trade and Economic Affairs in March 1966 said in part: "The U.S. members made clear that the U.S. government was not requesting U.S. corporations to induce their Canadian subsidiaries to act in any way that differed from their normal business practices as regards the repatriation of earnings, purchasing and sales policies, or their other financial and commercial policies". While this would appear to constitute an exemption by the United States of Canada from the guidelines, no formal exemption has been made. At the end of March, 1966, the government of Canada decided to issue to subsidiary companies in Canada the guiding principles of "good corporate behaviour" and, in addition, to collect for the first time data on, among other things, export and import performance and on selected quarterly capital transactions from the larger subsidiaries. The usefulness of such data will increase as the passage of time permits of comparisons and the identification of abnormal behaviour. It has been suggested previously (see Performance of Firms), that the guidelines questionnaire should be made operational and mandatory.

56. Since the behaviour of American subsidiaries in Canada can be significantly affected by compliance with the American guidelines and controls, American guidelines and surveillance machinery should be matched by Canadian guidelines and surveillance machinery. As the former become operational, so ought the latter. An effective set of United States balance of payments controls could have seriously adverse consequences for the Canadian economy, and Canadian policy-makers must be prepared to put countervailing Canadian policies into operation, if and when that becomes necessary.

57. Divergent views exist within Canada in appraising the issue of extraterritoriality. One school of thought prefers to take a "realistic" approach which is centered on the estimation of economic losses to Canada, particularly in reference to trade opportunities foregone by American-owned subsidiaries. The main difficulty with this approach, however, is our ignorance of the economic costs and the impossibility of determining their present extent, much less their possible future magnitude. Others have taken a second approach, distinguishing between good extraterritoriality and bad, referring in particular to American anti-trust legislation as having beneficial effects in Canada, particularly in the light of the relative weakness of Canadian anti-combines policy.

58. Both of these approaches miss the main point, which is the creation of an elaborate legal and administrative apparatus by the American government to implement their legislation abroad in regard to American goods, technology, and the actions of subsidiaries. The general picture which emerges from our study is one of a tight legal and administrative network capable of being turned to any objective in foreign policy or to meet any future stringency, such as a further deterioration of the American balance of payments position. This poses for Canada a basic political problem, namely, that for an uncertain future the "elbow room", or decision-making power of the Canadian government has been reduced in regard to economic relations involving American subsidiaries. The essence of the extraterritorial issue is not the economic costs - and in the interacting network of Canada-United States relations, there may even be economic benefits from Canadian compliance - but rather the potential loss of control over an important segment of Canadian economic life.

59. The proposals suggested above are oriented toward attempting to restore somewhat, active Canadian jurisdiction as a countervailing force in this situation. In addition, if a subsidiary

firm included Canadian citizens among its shareholders, on its board of directors and in its senior management, an additional assurance is provided that some Canadian interests will be represented in the formation of corporate policies. There is no simple solution to the problem of extraterritoriality. Canadian participation in the equity of these companies may be a necessary, though not a sufficient, condition to deal with the issue of extraterritorial jurisdiction in Canada related to foreign investment.

Effects on Canadian Policy-making

60. The interrelationship of foreign investment and specific instruments of Canadian policy, in terms of both present and potential objectives, has been a recurring theme of this Report. The exercise of monetary-fiscal policies is complicated by foreign investment, though largely as one dimension only of the openness of the Canadian economy and its integration with the American economy; the closeness of trade ties with the much larger American economy severely constrains the efficacy of independent Canadian policy to combat unemployment and inflation. The constraint on Canadian policy associated with dependence on a continuing inflow of foreign capital is as relevant to portfolio as to direct investment, and thus is not simply, or even primarily, a matter of foreign ownership. Furthermore, it is likely that the most effective means for lessening these constraints would be to return to a flexible exchange rate system.

61. The many other interrelations of direct investment and Canadian policy, actual or potential, have been spelled out elsewhere, (as in para. 35 of The Multi-National Corporation and the Nation State). It has

been noted, for example, that there are important balance of payments effects from direct investment both through the actions of the firms themselves and the guidelines of the United States government; and that industrial policies to increase efficiency through tariff reduction, more effective anti-trust legislation, and aid to research are crucially affected by the special considerations relating to the multi-national firm. The fact that the economic horizons of the multi-national firm are wider geographically and often longer in time may reduce its susceptibility to some conventional policies and require new approaches to achieve given objectives. Some of the present trends in the international economy may further increase the importance of direct investment.

62. In the light of these considerations, a case exists for international and supranational policy capable of dealing with the multi-national firm at its own level. Canada's present status as a recipient of direct investment, and its potential as a base for multi-national corporations, suggests the appropriateness of Canada sponsoring international initiatives on policy toward the multi-national corporation, though no immediate results seem likely.

Of more immediate relevance are new national policies based on the recognition that the general autonomy of Canadian government policy requires a stronger government presence to counterbalance the power of multi-national firms and, on occasion, foreign government power exercised via these firms. Analagous reasoning suggests that, in some instances at least, similar developments arise from Canadian direct investment abroad, and may also require particular government attention from time to time on implementing policy.

Canadian participation and a Canadian presence

63. The existence of minority shareholdings in what would otherwise be private companies wholly-owned by a foreign parent would make the subsidiary a more distinct and separate entity. This can be expected to facilitate the decentralization of decision-making within the multi-national enterprise and increase Canadian representation on boards of directors. In both respects, this facilitates the expression of private Canadian points of view through the presence of Canadian citizens as managers, directors and shareholders and may provide additional channels for the Canadian government for the exercise of its policy.

Conclusion

64. The most serious cost for Canada resulting from foreign ownership is the intrusion of American law and policy into Canada. For Canada, the essential feature of the problem is not the economic cost, but the loss of control over an important segment of Canadian economic life. While there are no easy solutions to extraterritoriality, Canadian national policy should be directed toward strengthening Canadian law and administrative machinery to countervail extraterritorial operations of American law and administrative machinery.

65. Foreign direct investment tends to shift the locus of decision-making outside of Canada and risks reducing the capacity of the Canadian government to implement its decisions in the public interest. Increasing the Canadian private presence in the decision-making of foreign-controlled subsidiaries would facilitate the expression of Canadian points of view and provide a vehicle for the Canadian government for the exercise of its policy. More generally, the Canadian public interest would be directly served by new national policies which recognize the need for a stronger government presence

to countervail the power of multi-national firms and, on occasion, foreign government power exercised over these firms.

viii. Canadian Direct Investment Abroad

1. Between 1954 and 1964 Canadian direct investment abroad rose from $1,619 million to $3,350 million. The latter figure was a significant component of Canada's long-term investments abroad of $7.3 billion and of gross external assets of $12.2 billion at the end of 1964. In per capita terms Canadian direct investment in the United States greatly exceeds American direct investment in Canada, although about 40 per cent of the former is in turn owned by residents of the United States, and the relative impact of direct investment in Canada is clearly far greater. The ratio of Canadian direct investment assets abroad to foreign direct investment assets in Canada has fallen from 27 per cent in 1951 to 21 per cent in 1964, so that the latter is now about the 1926 ratio of 22 per cent, that is, in recent years Canadian direct investment abroad has not kept pace with foreign direct investment in Canada.

2. These investments abroad are most heavily concentrated in industrial and commercial concerns. Since 1954 railway and other utility investments have tended to decline as a proportion of the total,

while industrial (excluding beverages) and financial investments have risen; similar trends are evident since 1939. Thus industrial and commercial investments rose from 31 per cent to 41 per cent of the total in the decade to 1964, financial and miscellaneous from 1 to 6 per cent, while the share of beverages has declined from 27 per cent to 22 per cent, that of railways and other utilities (including pipelines) from 26 per cent to 14 per cent. Petroleum rose from 7 per cent to 9 per cent and mining was unchanged at 8 per cent of the total.

3. As is the case for Canadian trade, these investments are heavily concentrated in the United States and the United Kingdom, with fully 60 per cent and 14 per cent so accounted for in 1964. Europe accounted for another 6 per cent, Australia 4 per cent, and other America (apart from Latin America) for 8 per cent. Less than 10 per cent of such direct investment found its way to Asia, Africa, and Latin America together, where most of the underdeveloped countries of the world are to be found. In the period 1954-64 the share of the United States fell sharply from 76 per cent to 60 per cent, with the United Kingdom, Europe, and other America sharing almost all of the gain.

The United States and the United Kingdom together in 1964 accounted for 76 per cent of all the industrial and commercial direct investment capital abroad, 92 per cent of petroleum, all of railways, 13 per cent of mining, 64 per cent of other utilities, 90 per cent of assets in financial concerns, and 47 per cent of other concerns.

4. It was noted above (see Performance of Firms) that a relatively small number of large firms account for a high proportion of all foreign direct investment in Canada, reflecting among other things the fact that it is the larger firms which are more likely to invest abroad. This picture is repeated to an even greater extent in the smaller total for Canadian direct investment abroad. The 13 largest firms involved accounted for 70 per cent of such investment abroad in 1963. The next 8 largest firms accounted for 7 per cent, the next 38 largest for 12 per cent, and the remaining 300-350 firms for 11 per cent.

5. Non-residents have a substantial equity in Canadian direct investments abroad, amounting to 37 per cent of the total in 1954 and 47 per cent in 1964. About four-fifths of this non-resident equity is concentrated in the United States. The

classification of ownership is the geographical one of residency abroad. The great bulk of non-resident ownership of Canadian direct investments abroad consists of investments abroad by Canadian companies whose voting stock is in turn controlled by foreign companies or by foreign citizens resident abroad. In this important sense, a significant portion of Canadian direct investment abroad is not really a Canadian asset. In some industries, however, there are important examples of direct investment abroad owned by Canadian citizens who are resident abroad.

6. Why do Canadian firms set up branches and subsidiaries abroad rather than serve the foreign market by exports or a licensing agreement? The answers, judging by a limited survey of some of the larger Canadian firms investing abroad, are similar to the reasons for direct investment in Canada. In some cases, they involve a desire to secure assured access to a primary resource abroad. In manufactures, foreign tariffs and other import restrictions play a very important role in inducing firms to locate abroad rather than export from Canada. Sometimes transfer costs and low costs abroad for certain inputs have been a factor. The preference for direct investment over licensing

reflects the fact that the latter may not be a feasible alternative where products or processes cannot be patented, trade marked, or otherwise protected, as well as the desire to maintain managerial control over the operation. A substantial part of Canadian direct investment abroad simply reflects the fact that transit through the United States provided the most economical route, as in the case of much railway and pipeline investment. Another substantial portion represents industries in which Canada produces at or above world standards of efficiency. The considerable Canadian expertise in these areas has found its way abroad not only via exports but also, for the reasons noted, via direct investment and licensing. Primary metals, paper and allied products, banking and insurance, and electric power are cases in point. Some other significant examples, such as the heavy investment in alcoholic beverages in the United States, may also reflect temporary historic circumstances which Canadians were in a favourable position to exploit.

7. While data are not available for a definitive comment on this, it appears that direct investment abroad by secondary manufacturing industries has

(with some notable exceptions) played a proportionately smaller role relative to the role of secondary manufacturing industries in the Canadian economy. This is perhaps not surprising since one would expect that, as with exports, a country's direct investments abroad would tend to be concentrated in industries where it has more advantage relative to others. No doubt there will be more direct investment abroad as Canadian secondary manufacturing industry becomes more efficient, but several other factors will help determine the extent of this. The reduction of tariff and non-tariff barriers to trade, particularly if pursued further, would increase the role of exports relative to direct investment abroad where these are alternatives. At the same time, the foreign-owned sector of Canadian industry has affiliates abroad which can provide the distributing and other functions of foreign affiliates. It is true that foreign-owned firms in Canada now have substantial direct investments abroad, but much of this is not concentrated in secondary manufacturing as such.

8. Any future expansion of Canadian-owned direct investment abroad is likely to be symptomatic of the increasing efficiency of Canadian-owned firms in

Canada. Success at home creates the sound base for expansion abroad. Policies designed to increase the quantity and quality of Canadian-owned firms at home are likely to be one of the most important means by which Canada will increase its stature as a foreign investor.

9. Many of the issues regarding foreign direct investment in Canada apply to Canadian direct investment abroad. There is the economic benefit to the host country paralleling the economic benefit to Canada from foreign direct investment, a benefit that is potentially large for the less developed countries. But there are also questions to be raised regarding the corporate behaviour of Canadian firms abroad similar to those raised with respect to foreign firms in Canada. Thus, nine-tenths of the value of Canadian direct investment in the United States in the early 1960's was in enterprises which were unincorporated branches or in which 95 per cent or more of the voting stock was held in Canada. A major difference is that Canadian direct investment in the United States and Europe is a small proportion of industrial investment in these countries, with the exception of a few industries. The same cannot be said for Canadian direct investment in certain underdeveloped

countries of the western hemisphere in particular, where concern about the economic and political effects of Canadian direct investment is not unknown. The legitimate concern of Canadians about foreign investment in Canada should be matched by an insistence that Cánadian firms abroad fully respect the interests of the host country.

ix. Conclusion: The Major Issues

1. Six major issues face Canada and its policy-makers as a result of foreign ownership and control of Canadian economic activity:

- the benefits and costs of the multi-national corporation
- the availability of information about corporations
- concentration of market power and restrictive trade practices by firms
- the performance and efficiency of firms
- extraterritoriality
- Canadian participation

2. The multi-national corporation is an economic and political reality of the modern world. Canada must come to terms with this fact of life. The multi-national corporation creates both benefits and costs for Canada. Canadian policies must be directed toward increasing the benefits and decreasing the costs of foreign direct investment. Because the multi-national corporation straddles

national borders, there is a need for international initiatives and international cooperation as an essential ingredient of national policy. But global policies are not imminent and foreign ownership and control is so important in Canada that purely national policies are needed now. At the core of Canadian policy must lie a determination to <u>recognize</u> the existence of the multi-national corporation, the opportunities it creates and the constraints it imposes. Where the foreign corporation is not truly multi-national but defers to the authority of a foreign government, then Canadian policy must be directed toward compelling adherence to Canadian law and policy in its Canadian operations, thereby causing the firm to become multi-national in fact. In this way, Canadian <u>national</u> policy would serve emerging <u>international</u> goals.

3. Far too little is known in Canada about the operations of large corporations, both Canadian-owned and foreign-owned, which often dominate the industries in which they operate. Without adequate information, it is difficult to formulate policy. One of the most insidious forms of monopoly power is the monopoly of knowledge. The privileges that accrue from incorporation must be matched by

obligations to disclose fully and widely to the variety of interests on whom the activities of corporations impinge. A corporation should not be permitted to avail itself of the special non-disclosing rights of the private company when any one of its shareholders is a public company either in Canada or in the foreign jurisdiction where it is incorporated. The Canadian government acting singly or in concert with the provinces, must avail itself of all means by which to require corporations to make available more information on their operations and activities. The information sought must be tailored to meet three requirements: public disclosure, economic analysis, and surveillance. The two latter requirements necessitate the availability of information which aids but goes well beyond the needs of the public itself. For purposes of economic analysis, the Dominion Bureau of Statistics must collect and analyse data made available by corporations on a confidential basis and published in aggregative form which does not permit identification of individual companies. For purposes of surveillance, relevant government departments and agencies must collect and use data on individual companies on a confidential basis.

4. Problems due to "bigness" in business, problems due to marked inequality of firm size, and problems due to monopolistic control of markets by a small number of sellers are of major importance in the Canadian economy. Foreign direct investment has had both positive and negative effects on the degree of competitiveness of the Canadian economy; it has not clearly increased competitiveness. Many foreign-controlled firms in Canada are oligopolists, and many oligopolistic firms in Canada are foreign-controlled. There is need for more effective Canadian policy at the national level to maintain competition within Canada, as well as Canadian initiatives and cooperation globally. Canadian anti-combines policy must be used more vigorously to promote competition and inhibit trade practices not in the public interest, though this should not preclude facilitating mergers to rationalize inefficient Canadian industries. Tariff policy must be centrally directed to promoting competition in the public interest. Furthermore, the recognition that firms with substantial market power have some freedom to determine their own goals means that

there is a need for a strong Canadian public presence to countervail private economic power. When these firms are foreign controlled, the same necessity exists, as well as the need to countervail foreign government power as applied through foreign private power.

5. The performance and efficiency of many Canadian firms, without respect to the nationality of ownership, does not meet "best-practice" standards elsewhere. Canadian-owned and foreign-owned firms are similar in performance in many respects. Environmental factors, particularly Canadian and foreign tariffs and the limited degree of competition in a number of Canadian industries, are the main identified determinants of performance. Canadian subsidiaries, though apparently as efficient as their domestic counterparts, are definitely less efficient than their parents. There are some special problems peculiar to foreign ownership such as the limited opportunity for Canadians to participate as shareholders, export restrictions within some international firms, and extraterritoriality. At the same time as Canadian anti-combines policy is strengthened and tariffs reduced, positive steps must be taken to increase efficiency

by rationalizing the structure of a number of Canadian industries. The proposed Canada Development Corporation could play a role in initiating consortia. The quality of Canadian factors of production, particularly Canadian management, needs to be increased so that all firms operating in Canada will be more efficient, and so that in the future it will be more likely that efficient production will take place under Canadian control. Steps should be taken, such as improvements in management education and the fostering of research and development, to encourage the private Canadian sector to undertake more of the Canadian ventures.

6. The most serious cost to Canada of foreign ownership and control results from the tendency of the United States government to regard American-owned subsidiaries as subject to American law and policy with respect to American laws on freedom to export, United States anti-trust law and policy, and United States balance of payments policy. The intrusion of American law and policy into Canada by the medium of the Canadian subsidiary

erodes Canadian sovereignty and diminishes Canadian independence. It implies that the American-based multi-national corporation is <u>not</u> multi-national but American. It creates political costs for Canada from American direct investment that seriously undermine the economic benefits. Exports foregone as a result of American restrictions on trade with Communist countries and directives to subsidiaries to help the American balance of payments create direct economic costs for Canada. While the ideal solution would be for the United States authorities to desist from viewing subsidiaries as instruments of American law and policy, a "second-best" solution rests with the Canadian authorities using Canadian law and Canadian administrative machinery to countervail American law and American administrative machinery.

7. Foreign ownership and control are presently pervasive in Canada and are likely to remain so. There is a need to ensure Canadian participation in the benefits of foreign direct investment and a Canadian presence in the decision-making of multi-national corporations. The proposed Canada Development Corporation could provide Canadian participation in new ventures too large for

private Canadian capital which might otherwise come under foreign ownership and control.

The Canadian tax system must be used so as to maximize benefits for Canadians from foreign direct investment. Canadian policy must come to terms with the contentious issue of minority ownership of foreign-owned subsidiaries.

Policies to encourage share offerings to Canadians involve both costs and benefits. On the one hand, the use of Canadian capital in this way involves foregoing other opportunities, risks creating disincentives to the future expansion of foreign-owned subsidiaries, and involves a sacrifice of tax revenue in proportion to the incentives offered and taken. On the other hand, it increases the supply of Canadian equities in the face of a rapidly growing demand for equities that may otherwise continue to spillover into the United States. It facilitates disclosure, and provides levers for dealing with extraterritoriality and for public surveillance.

While there is no foolproof way by which a balance can be struck for or against such a policy, some strengthening of incentives to encourage large corporations, including foreign-owned subsidiaries, to offer their shares to Canadians appears to be in order.

III POLICIES

i. Policy Alternatives

1. All countries have a policy toward foreign investment, a policy of laissez faire being itself a policy. There are lessons to be learned for Canada by comparing Canadian policy with that of other countries. It must be recognized, however, that because of the great variations in circumstances confronting individual countries, foreign investment policies suitable for one country may not be suitable for another.

2. Despite these variations, there seem to be certain basic factors which have guided policy-makers in many countries. To begin with, there is a concern on the part of governments to maintain the political independence and sovereignty of their nation-state. There is a consensus that, beyond some upper limit, the foreigner becomes dominant and therefore dangerous, but there is little consensus on where that limit is. No other country, however, seems prepared to tolerate so high a degree of foreign ownership as exists in Canada. Furthermore, nearly every country has certain industries which are reserved

almost exclusively for nationals because of their "vital" nature. Usually, the list of such industries is small and typically relates to the communications and financial sectors. Also, every country has its "prestige" firms, and some of these may have taken on the status of "national monuments"; even rumours of foreign take-over of these can have traumatic consequences.

3. There is also concern to ensure that the benefits to the host country of foreign investment are maximized in terms of the development of natural resources, the transfer of technology, and the competitive stimulus, or "imitation effect", provided to domestic firms. For these reasons foreign business is permitted, while at the same time steps are taken to build up or maintain the strength of the domestic business sectors either by imposing restrictions on foreigners or by providing domestic firms with incentives and subsidies. The aim is to avoid becoming dependent on foreigners in important industries, especially those where technology is important.

4. In attempting to give specific form to these general policy objectives, different countries concentrate on different aspects of

the problem and use different policy instruments to achieve solutions. Tax measures, foreign exchange controls, and legal restrictions, along with various other instruments are used in varying proportions by different countries to implement their policy objectives. Few countries, however, have been able to devise a systematic set of specific instruments to achieve these policies. There has been a tendency for countries to rely on *ad hoc*, case by case, approaches, partly because of the complexity of the problem, partly because, to many countries, the problem is new, and partly because policies have been closely related to changing foreign exchange needs. This pragmatic approach is tolerant of changes-of-mind. The United Kingdom has, in the past, adopted a *laissez-faire* attitude, but recently has required "assurances" from foreign firms in some cases before permitting foreign investment. France was favourable to foreign investment until approximately 1960, moved toward the regulation of entry of foreign firms in the early 1960's, but has recently turned back to a more liberal policy. Belgium has tried to attract as much foreign capital as possible, but very recently moved to prevent foreign take-over of Belgian companies in the face of a rumoured take-over

bid of its prestigious Petrofina S.A. by Standard Oil of California. Japan is a notable exception in these respects, however, having long-standing, and, in its broad outlines, well articulated policy on the question of foreign investment, though the trend is toward liberalization.

5. The policy-makers of many governments have encountered difficulties in designing systematic approaches to the problem because of their inability to put the issues raised by foreign investment in their proper time perspective. For example, because in many countries the Treasury, the Ministry of Finance, or the central bank have been the governmental agencies most concerned with foreign capital, the problem has been viewed to an excessive extent from a foreign exchange perspective. This has led to a short-run view by government and a conflict of interest between corporations and governments. Governments, concerned about immediate balance of payments effects, have often made decisions affecting foreign investment without reference to its long-run effects on the extent of foreign control and the competitiveness of the economy. Corporations, on the other hand, undertake foreign investment not for short-run profits but to establish a basis for

future growth and a long-run market share. This difficulty, however, is being overcome as evidenced by current practice in the United Kingdom and France where the Treasury and Ministry of Finance, respectively, consult with various parts of the government to ensure that the structural implications of foreign investment are considered.

6. Furthermore, some governments have underestimated the multi-nationality of the multi-national firm, and have chosen to focus on the fact that a local company is foreign-owned rather than the fact that foreign parent companies have subsidiaries abroad which they control. France, for example, during the brief restrictive period, found that restrictions on the entry of foreign firms to France caused them to enter Belgium and export to France from there. Similarly, some countries try to attract foreign capital by offering concessions, though this only invites the foreign investor to play one country off against another to the loss of all host countries.

7. Finally, most policy-makers have tended to focus upon new foreign investment, thereby neglecting established enterprises. This is not important so long as foreign firms do not occupy dominant positions in the economy. When foreign firms grow to occupy

such positions, however, then their impact upon research, exports and finance, and their relationship with affiliates, become matters of importance to the host country. Few countries have institutions for dealing with foreign investments at this point.

ii. Policy Elsewhere

1. It is useful to consider more systematically the policies and policy instruments which have been developed by France, the United Kingdom and Japan to deal with foreign investment. Thereby one sees more clearly both the effect of differing national circumstances - whether economic, political, social or cultural in origin - on policy and the range of policy alternatives currently in use in other advanced industrial economies which have had to wrestle with the problem of the penetrative powers of foreign, particularly American, corporations in recent years.

2. There are three important differences between these countries and Canada which should be borne in mind, however. First, each of these countries has essentially a unitary rather than federal system of government with power largely vested in the central government; it is likely that this facilitates the formulation of national policy with respect to foreign ownership. Second, each of these countries has an exchange control apparatus; though the primary purpose of the latter is to cope with foreign exchange problems, it can serve the further purpose of providing the machinery with which to screen foreign

investments. Third, each of these countries has significantly less foreign ownership and control than Canada. (About 8 per cent of the capital in French industry is foreign-owned and about half of the latter is American. If the large publicly-owned sector is excluded, however, foreign ownership of French manufacturing alone may be in the order of 15 per cent. United States ownership of capital in British manufacturing is about 8 per cent. Foreign ownership of Japanese capital is apparently significantly lower than in France or the United Kingdom.) They are able to formulate policy in a context where both the benefits and the costs of foreign ownership can be presumed to be less than they are in Canada.

France

3. Any foreign firm wishing to invest in France - and any French firm wishing to make a direct investment abroad - must apply to the Ministry of Finance for permission. The policy covers foreign take-overs, foreign purchases of outstanding securities where control is involved, establishment of new subsidiaries and major expansion of old ones. Current emphasis is on the existence of (foreign) control and its extension, rather than on the capital flow itself. When Chrysler increased its interest in Simca from 25 to 63 per cent in 1963, no authorization was required since the shares were previously held by investors outside of France. But a similar case of extension of control by a foreign firm would require authorization under present policy. Again, in the past, established subsidiaries of foreign firms which expanded were treated the same as French firms. Now, major expansions involving an extension of control can require approval.

4. A firm will usually consult with the Ministry of Finance before submitting its application formally, thereby gaining the opportunity to make adjustments at an early stage. After a formal application has been submitted, the Ministry of Finance refers the

dossier to the Comité des Investissements Etrangers - composed of representatives of the major government departments, the Planning Commission and the central bank - which is the actual working committee which examines the application in detail. The application is then forwarded to the Grand Comité des Investissements, made up of Ministers and the Governor of the Bank of France, for final disposition. The Grand Comité is primarily concerned with cases of great importance and issues of principle. Legally these committees act in an advisory capacity only, with the Minister of Finance being sovereign in the final decision.

5. As well as controls over direct investment, France scrutinizes licensing agreements with foreign companies. All such agreements must be approved by the Ministry of Industries which tries to ensure, among other things, that the agreed payments are reasonable. The purpose of this agency is to help overcome the imbalance in payments for technology, or the deficit in the "technological balance of payments", which tends to be regarded by the French as a manifestation of a new kind of colonialism.

6. Underlying French policy is the objective of building up a strong national industry. The intent is to reduce the relative weakness of French industry. French firms, it is said, are too often small, family-owned and technologically backward, with management technique far behind practice in the United States. It is recognized that foreign investment can make a valuable contribution to stimulating French firms to greater efficiency. At the same time, however, the government wants to ensure that French-controlled industry is maintained in the process. There is apprehension that in industries where the American share is high - and in spite of the low overall level of American investment, the American share is very high in certain industries - French industry will disappear and France will be placed in a vulnerable position. In general, foreign investment is preferred where it stimulates but does not dominate.

7. The Machines Bull case is an interesting example of the attitudes of the French government and the nature of the problem in a number of respects. Bull, France's largest manufacturer of computers, was in financial difficulties in 1963 and General Electric was willing to provide a fresh injection of capital in return for minority

participation. After an abortive attempt to bail out Bull with French capital, the government agreed to the G.E.-Bull partnership, and G.E. ended up acquiring a larger share in Bull than originally proposed. The government has not given up, however, and is now considering the alternative strategy of building a large computer for its own use.

8. The Bull case, and its aftermath, is illustrative of the French view that the dominance of American corporations in certain technologically-advanced industries, such as aerospace, electronics and computers, should be challenged. The view is strengthened when the industry is closely related to defence. Hence, with respect to Bull, the French were unwilling to rely on an American-controlled firm providing computers with important military uses at a time when it was disengaging itself from the United States militarily. In general, the French feel that other countries should build up their own industries as competition for the Americans. Technology, it is argued, changes rapidly, and so can the relative strength of firms. A firm at a disadvantage one moment may make a technological break-through putting it ahead in the next period. To give up on this possibility would be to acquiesce in a

position of technological backwardness.

9. Though there is strict surveillance of inward investment, French policy has, in fact, been very liberal in the last year or so. France is hoping that its own positive measures will be sufficient, at a time when American outward investment is constrained by American balance of payments difficulties and consequent policies, to prevent excessive American take-over. Should this not be true it is possible that France would take more active steps to keep American investment in check.

United Kingdom

10. In the United Kingdom, as well, all inward and outward flows of foreign investment require approval, under the foreign exchange laws. Any firm wishing to invest in England must file an application with the Bank of England, which acts as agent for the Treasury in the matter. The Treasury's main concern traditionally has been to ensure, for balance of payment's reasons, that a sufficient portion of the total investment is financed from external sources, and that local borrowing associated with foreign direct investment is kept within reasonable proportions. A rule of thumb, though subject to modification if an investment is deemed sufficiently beneficial, is that 100 per cent of the fixed assets be financed from abroad. Other ministries examine the applications for investment from the point of view of their own responsibilities. In particular, each application receives scrutiny from the sponsoring department of the particular industry involved in order to evaluate the possible impact of the foreign investment on the economy's structure and performance. There are, however, few firmly articulated ideas of what policy should be.

11. In some very important cases, the government has required certain assurances from the companies in question before it would approve the application. In 1960, Ford was allowed to buy out the local shareholders, and thereby moved from majority to complete control, only after it gave assurances on numerous aspects of its performance, namely, that it would continue its major expansion program, continue to plow back a high proportion of the profits, maintain continuity in management policies, continue to obtain a high proportion of its components in the United Kingdom, and keep its exports high. Again, when Chrysler was allowed to purchase 30 per cent of the equity of Rootes, a condition was attached that it would not attempt to acquire a majority holding without permission.

12. These assurances do not constitute a well-thought out policy; rather, they indicate some of the apprehensions about the multi-national corporation present in the United Kingdom. The other significant aspects of British policy are encouragement to foreign firms to locate in the depressed regions and the recently created Industrial Reorganization Corporation to aid in the rationalization of British industry. While the consulting machinery is used and can be presumed

to have some effect on decisions, it seems clear that the overriding concern with the balance of payments would inhibit any policy that would risk serious interference with the inflow of capital. At the same time, Britain's historic commitment to the free flow of capital internationally and the hope that foreign business will provide a much-needed stimulus to economic growth preclude serious interference.

Japan

13. The Japanese program for screening foreign investment is similar, in a formal way, to those of France and the United Kingdom. A special agency, the Foreign Investment Council, makes the final decision on whether an inward flow of investment or technology should be allowed on the basis of recommendation of a sub-committee on which various ministries are represented. The greater part of the work of examining and deciding upon applications is conducted by the responsible ministry, which is nearly always the Ministry of International Trade and Industry.

14. Japan's uniqueness lies in the fact that its policies on foreign investment and the import of foreign technology have been very strict, largely excluding foreign capital and controlling inward flows of technology. The government has exercised strong pressure to encourage licensing rather than direct investment. When foreigners are allowed equity participation, a majority interest is seldom permitted; if it is, additional steps are taken to ensure that the Japanese partner has control. In each case, the foreigner must bargain first with a Japanese company and then with the government. The

latter intervenes to ensure, so far as possible, that the agreement between the foreign and Japanese firms does not lead to Japanese "dependence", upset the "balance" of the particular industry, cost too much, cause the Japanese firm to lose control, or have limitations on the right to export. An exception is found in a certain category of wholly-owned subsidiaries, the so-called "yen based companies". These companies are regarded as Japanese firms and are completely free to expand as they wish, in theory. In fact, informal restrictions can still be placed on them by the government through its control of taxation and other means.

15. A recent liberalization program reflects the trend of Japanese policy. While joint ventures had been permitted before, the foreigner almost always was required to take a minority interest. The liberalization permits ventures in which the foreigner has a 50 per cent interest, as well as exceptional cases in excess of this. But liberalization is not only proceeding slowly, it is taking place under controlled conditions. Its pace and character are designed to ensure that there are no foreign take-overs of important economic sectors. It applies only to new investment, and the latter is permitted only

in industries where Japanese firms are strong enough to compete effectively. The intent is to permit foreign business to enter, but in order to strengthen rather than weaken Japanese business. Japan has not abandoned its long-standing policy of importing and assimilating foreign technology while guarding against the dangers of foreign ownership. At the same time, however, the external pressures on Japan to liberalize further are strong.

16. In view of the extraordinarily rapid growth of the Japanese economy, Japan's policies toward foreign technology and investment cannot be judged to be crippling. Japan has been able, without much foreign direct investment, to absorb technology from abroad rapidly, and to develop its own technology. In many cases, the Japanese have been able to buy technology through licensing agreements at reasonable prices without surrendering control. While in many ways Japan is a special case which cannot be copied, the success of its policy clearly illustrates that it is possible to break apart the direct investment package and separate technology from control, and to bargain for the terms on which technology is obtained from abroad.

17. The efficacy of these policies for Japan reflects Japan's bargaining power vis-a-vis the multi-national firm, which rests on a number of factors. For linguistic and cultural reasons, it is difficult for a foreign firm to operate in Japan except in close cooperation with a Japanese firm. The long tradition of strong government control internally gives the government leverage in dealing with foreign firms. Foreigners are reluctant to risk exclusion from the large and growing Japanese domestic market. Furthermore, the Japanese operation can be a potential export base for Southeast Asia. Finally, much of Japan's bargaining strength stems from the fact that it has giant firms of its own, with large conglomorate business groups having played an important role in Japan's development strategy. But Japan's bargaining strength does not extend equally across all technological borrowing from the simplest to the most sophisticated techniques. Foreign firms can and do demand much better terms for equity participation and other aspects when it comes to tne latter. The liberalization in Japan reflects in part a desire to exploit such advanced techniques for international markets.

iii. Canadian Policy

1. While there has been concern among Canadians for some time about foreign, especially American, ownership and control of Canadian industry, it has, in general, been the policy of all levels of Canadian government not only to permit, but to actively encourage, foreign investment. Although Canadians have been anxious to maintain political independence, they have also wanted to maintain a high standard of living and develop the country's natural resources.

2. Unlike France, the United Kingdom and Japan there is no formal screening procedure for foreign investment and no governmental agency with which a foreign investor must consult prior to undertaking direct investment. While this absence reflects, compared to most countries in the world, a particularly liberal policy toward foreign direct investment, it does not mean that Canadian policy has been non-existent. In particular, the Canadian government has discouraged foreign ownership or control of certain key sectors and industries: American control of railways in the post-Confederation period; airlines, bus lines, and radio stations in the 1920's and 1930's; television stations and insurance companies in the 1950's; and

newspapers and banks in the 1960's. Canadian ownership and control have been ensured by the setting up of Crown corporations, as in the cases of Air Canada and the Canadian Broadcasting Corporation.

3. The substantial increase in foreign direct investment since 1950 has resulted in a number of specific policy steps. The Canadian tax structure has been altered in various ways to encourage foreign investors to do things deemed consistent with the Canadian interest. The balance of payments implications of foreign investment have received considerable attention. Incidents of American extraterritoriality and the issuing of American guidelines to direct investment firms have created much apprehension and some new policy initiatives, of which the most notable is Canadian guidelines for foreign-owned firms. No systematic overall policy has emerged, however, and Canadian policy remains one of the most liberal in the world.

4. A brief survey of recent governmental actions in the area of foreign investment permits of a better understanding of the nature of Canadian policy. In 1957, an amendment to the <u>Canadian and British Insurance Act</u> authorized

a procedure to enable life insurance companies to "mutualize" in order that control of Canadian life insurance companies might be retained in Canada, and required that the majority of the directors of these companies be Canadians resident in Canada. In 1958, applicants for radio and T.V. licences were required to be Canadian citizens. In 1960, it was decided that in order to obtain a gas and oil lease in the North-West Territories a company must have its stock listed on a recognized Canadian stock exchange. The Eisenhower-Diefenbaker Joint Statement on Export Policies of that year, calling for full consultation between the two governments when export policies and laws were not in harmony, was intended to mitigate tensions resulting from the extraterritorial extension into Canada of American law with respect to trade with communist countries. Similar provisions for consultation on anti-trust and anti-combines enforcement, resulting from Canadian concern over the extraterritorial extension of United States law, were embodied in "Anti-Trust Ratification and Consultation Procedures" or the Fulton-Rogers agreement. Also, in 1960, a series of tax incentives were established to encourage Canadian residents and firms to invest in domestic enterprises.

5. In 1961, withholding taxes on interest and dividend payments to foreigners and on the earnings of unincorporated foreign-owned business were increased, though more to reduce upward pressure on the exchange rate and reduce unemployment than to discourage the inflow of capital. Also, government support of the Industrial Development Bank in 1961 was increased to reduce the need for small Canadian business to sell out to foreign firms. In 1962, the <u>Corporation and Labour Unions Returns Act</u> promised to lead to the disclosure of more information on all (larger) private companies, including those which were foreign-owned and controlled. Another measure introduced the same year gave special tax treatment for research and development in order to reduce Canadian dependence on foreign research.

6. The Department of Industry was created in 1963 with responsibility for promoting the growth and efficiency of manufacturing industries in Canada by such means as encouraging more industrial R & D in Canada and facilitating the rationalization of Canadian secondary manufacturing industries. Measures were introduced to encourage Canadian private investment, foreign investment in bonds rather than equity, and Canadian equity

participation in foreign-controlled firms. Special depreciation provisions were offered to manufacturing and processing enterprises provided that at least 25 per cent of the firm was owned by Canadians and there were resident directors to the same degree. Certificates of exemption from the withholding tax on interest payable on Canadian bonds were authorized for certain types of foreign financial institutions in order to encourage foreign investment in Canadian bonds. The withholding tax on dividends to foreigners was reduced for firms whose shares were listed on a Canadian stock exchange and whose voting stock was not more than 75 per cent owned by a non-resident and one-fourth of whose directors were residents. The regular withholding tax was extended to apply to management fees paid to non-residents.

7. In 1964, several acts were amended in order to retain the Canadian ownership and control of federally-incorporated insurance and trust and loan companies by limiting the proportion of total shares which might be held by all non-residents to 25 per cent while limiting the proportion held by any one non-resident (or resident) to 10 per cent. In 1965, Canadian firms wishing to advertise to Canadians in a non-Canadian periodical or newspaper,

with the important exceptions of the Canadian editions of Time and Reader's Digest, were forbidden to charge the cost of their advertising as a business expense, thereby inhibiting the sale of Canadian publications to foreigners. In 1966, partly in response to American balance of payments policy, guiding principles of good corporate behaviour were issued to foreign-owned firms operating in Canada and questionnaires were sent out to the larger foreign-owned firms requesting information on various aspects of performance; in early 1967 an analysis of the data collected was published.

8. The Bank Act revision, announced in 1964 and introduced in 1965, extended to banks the limitations on ownership previously applied to other financial institutions, namely, that the proportion of shares which might be held by all non-residents was limited to 25 per cent and the proportion held by any one non-resident (or resident) to 10 per cent; in early 1967, it was established that the only foreign-controlled bank, Mercantile Bank, was subject to the provisions of the Bank Act as revised, but that it would be given time to comply. Also, in 1966, interest payments on all government bonds and debentures of federal, provincial and municipal governments were exempted from the

withholding tax in an attempt to channel foreign investors toward Canadian bonds as opposed to Canadian equities.

9. The most important point of a positive nature to emerge from the survey is that a clear Canadian policy at the level of the federal government has taken shape over the past decade to maintain Canadian ownership and control of federally-incorporated financial institutions, while the pre-existing policy of maintaining Canadian ownership and control of the media of communication has been strengthened. In general, this reflects the Canadian commitment, a liberal policy toward foreign investment notwithstanding, to protect Canadian business in these key sectors of the economy and the society. The rationale transcends narrowly economic considerations. Communications media lie at the heart of the technostructure of modern societies. Canadian ownership and control facilitate the expression of Canadian points of view. Financial institutions, because of their pervasiveness and their potential as bases for influence and control, constitute the commanding heights of the economy. Canadian ownership and control facilitate the exercise of Canadian economic policies. The key sector commitment,

and its variant, the key firm commitment, have not been extended, however, by the development of any policy instruments to deal with foreign take-overs outside these sectors.

10. Evaluations of the other policies have been offered at various points in the preceding sections. Joint consultation procedures between the governments as a means of dealing with the extraterritorial extension of United States law into Canada have been relatively ineffectual in blocking this erosion of Canadian sovereignty. Tax incentives to encourage Canadian borrowing via debt rather than equity have encouraged foreign debt without apparently discouraging foreign equity, since direct substitution is not easy. Tax incentives to encourage Canadian equity participation have led to some new share issues, but have made no serious dent in either the prevalence of the wholly-owned subsidiary or the shortage of Canadian equities. The use of tax incentives results, in part, from the efficacy of this instrument relative to alternative instruments for constitutional reasons and for ease of application, but it seems clear that, to the extent that shifting foreign borrowing from equities to bonds and increasing Canadian equity ownership in foreign-controlled firms is deemed to be desirable

and feasible tax incentives per se, or at least the level of present incentives, have not been highly effective.

11. CALURA has largely failed to live up to its promise to create more disclosure on the activities of foreign-owned firms. The Department of Industry has quickly come to play an important role in fostering industrial research and development and in promoting the rationalization of Canadian secondary manufacturing industry. While the intent is to strengthen Canadian industry without respect to ownership, policies of this nature do have relevance to foreign investment, for they improve the environment within which Canadian-owned firms grow and compete and foreign-owned firms operate in ways that tend to increase the Canadian benefit from foreign ownership. The issuing of the guiding principles, by recognizing the relevance of the nationality of ownership to the performance of firms in the economy generally, constitutes an important policy initiative, though there is considerable scope for improvement by moving further in the direction of surveillance of foreign-owned firms.

12. Canadian policy toward foreign investment has been piecemeal and gradual, and apparently more so than policies pursued elsewhere. In some part,

this is the result of the Canadian federal system. Jurisdiction over subsidiaries lies, to some extent, with the provinces, and provincial governments have generally not distinguished between residents and non-residents of Canada in their policies on investment. More generally, Canadian policy has been consistent with a favourable attitude on the part of Canadian governments at all levels toward foreigners who wish to invest in Canada. This attitude has deep roots in Canada, and is unlikely to change significantly.

13. The major deficiency in Canadian policy has been not its liberality toward foreign investment *per se* but the absence of an integrated set of policies, partly with respect to both foreign and domestic firms, partly with respect only to foreign firms, to ensure higher benefit and smaller costs for Canadians from the operations of multi-national corporations.

IV. OBJECTIVES

1. Canadians want national independence and economic growth. They want to increase the benefits from foreign ownership and reduce the costs. They want a national economy that functions efficiently within the world economy. Canadian history bears witness to those aspirations.

2. It is a function of government to translate those aspirations into objectives for national policy. On the basis of the discussion in the Report to this point, those objectives can be stated as:

- to require foreign-owned subsidiaries in Canada to behave as "good corporate citizens" of Canada, and to perform in ways that are fully consistent with Canada's economic and political interests.

- to improve the overall efficiency of the Canadian economy, and the performance of Canadian corporations, Canadian-owned as well as foreign-owned, in ways which will facilitate the capacity to generate self-sustained economic growth.

- to take positive steps to encourage increased Canadian ownership and control of economic activity, in ways that will facilitate the achievement of greater national independence and continuing economic growth.

3. These objectives should be pursued only in the context of the explicit recognition of the constraints within which policy is formulated by the Government of Canada. National policies with respect to foreign investment must take full account both of the constitutional rights of the provinces and the property rights of foreign owners. Canadian respect for these rights is deeply ingrained and they should not be violated.

PROPOSALS

i. Benefits and Costs of the Multi-national Corporation

1. Foreign ownership and control of economic activity are pervasive in Canada. The multi-national corporation has evolved as a new entity capable of dealing directly with nation-states. Canadian policy must come firmly to grips with this development, for multi-national corporations are likely to become of increasing importance. Almost all government departments and agencies presently deal in some way with aspects of the activities of foreign-owned firms. A sharper focus and greater coordination are needed.

2. It is recommended that a special agency be created to coordinate policies with respect to multi-national enterprise. Its functions would be:

(a) Collect information necessary for the surveillance of foreign-owned firms; do research on foreign ownership on a continuing basis; disseminate information to relevant operating government departments and

agencies; specifically, take over the questionnaire procedure used under the guiding principles program, making it mandatory and operational.

(b) Examine licensing agreements, and facilitate the import of technology with minimum restriction on its use.

(c) Examine international market-sharing arrangements and international commodity agreements, and facilitate export promotion.

(d) Facilitate initiatives for international cooperation with respect to the multi-national firm in such matters as investment guarantees, harmonization of anti-trust policies, and international charters.

(e) Examine taxation procedures to ensure that Canada gets its proper share of taxes paid by multi-national firms.

(f) Facilitate the entry of new multi-national firms.

To highlight the importance of its work, it is recommended that this agency report directly to a Minister of the Crown.

ii. Availability of Information

1. It is a prerequisite to public discussion of government policy and the formulation and implementation of actual policy that more information be available on the activities of corporations, particularly large corporations, both Canadian-owned and foreign-owned. Information presently available is generally deficient, and in some respects grossly so, for meeting the three distinct purposes for which information is needed: public disclosure, economic analysis, and governmental surveillance of firms.

2. It is recommended that the following specific steps be taken with respect to company law, bankruptcy law, securities legislation, the Corporations and Labour Union Returns Act (CALURA), and the guiding principles of "good corporate behaviour" to the larger foreign-owned subsidiaries:

(a) Amend the Canada Corporations Act so that federally-incorporated private companies (as well as federally-incorporated public companies), without respect to the nationality of ownership, must file returns with the Department of Consumer and Corporate Affairs,

and make returns for all companies available to the general public; seek provincial cooperation to make this an effective means of obtaining public disclosure.

(b) Should (a) not prove an effective means to get public disclosure, consider creating a disclosure statute applicable to all corporations carrying on business in Canada, including provincial corporations, under the federal bankruptcy power, the statute to include a penalty provision imposing liability on the directors of a company which has failed to disclose required information when the company is subsequently unable to meet its debts.

(c) Use securities legislation, in cooperation with the provinces, to obtain improved disclosure from companies which issue shares to the public, it being recommended below that presently private companies be given stronger incentives to issue their shares to the public.

(d) Unless public disclosure is adequately met by (a) or (b), amend CALURA so that financial statements and schedules being filed under the Act, and not now being made available to the public, be made available to the public.

(e) Make the guiding principles questionnaire to foreign-owned subsidiaries mandatory; revise it so that the information sought is operational in terms of the surveillance of the activities of foreign-owned subsidiaries; and place its administration under the special agency recommended above to coordinate policies with respect to multi-national enterprise. The questionnaire could be confined to the larger foreign-owned firms. For comparative purposes, it is recommended that the questionnaire be sent to all large firms in Canada, it being recognized, however, that some of the questions by their nature apply only to foreign-owned firms.

iii. Imperfections of Competition

1. The maximization of the net economic benefit for Canadians from foreign direct investment requires that Canadian policy be directed to a greater extent than it has in the past to the maintenance of competition. The major need is for steps to maintain competition within Canada by anti-combines policy and by tariff policy, but there is scope for Canadian initiatives and cooperation to maintai n competition globally. While policies to maintain competition and countervail private economic power should be applied to all firms, without respect to the nationality of ownership, there is a special need to maintain a stronger Canadian public presence to countervail foreign private economic power and foreign government power as applied through the latter.

2. It is recommended that anti-combines legislation be revised and be applied more vigorously without respect to the nationality of ownership of firms. Combines have tended to be viewed by the authorities as a police problem rather than an economic problem. The concern has been with restrictive trade practices which could meet the test of evidence under criminal law rather than with statistical evidence of monopoly

and oligopoly and economic analysis of associated deleterious effects. Federal-provincial cooperation should be sought to the extent necessary to strengthen anti-combines law and policy. The revised law then needs to be applied with much greater vigour.

3. It is recommended that Canada undertake initiatives at the international level which will aid in maintaining competition globally. As a first step in promoting international cooperation based on a genuine international consensus, Canada should call on all countries to cease extending their particular anti-trust law and policy extraterritorially. Positive steps to block the extraterritorial intrusion of American anti-trust law are recommended below (see Extraterritoriality).

4. It is recommended that Canadian tariff policy, which presently facilitates imperfections of competition, be revised in order to promote competition in the public interest. Recommendations with respect to tariff policy are spelled out below. (See Economic Efficiency).

5. It is recommended below (see Economic Efficiency) that steps be taken to rationalize Canadian industry so as to increase its efficiency and enhance its

capacity to compete in markets at home and abroad. While anti-combines law and policy must prevent mergers which are not in the public interest and should, in general, be applied to industries rationalized under government auspices, the revision of the legislation must be done in a way that does not preclude the rationalization of industry in the public interest.

6. It has been recommended above that a special agency be created to coordinate policies with respect to multi-national enterprise. The present guiding principles assume that foreign-controlled subsidiaries are susceptible to moral suasion and thus implicitly recognize that these firms are typically oligopolistic. The agency will take over the administration of the guiding principles and render them operational as a means to exercise public surveillance over foreign-owned subsidiaries. Furthermore, the agency will examine licensing agreements and market-sharing arrangements so as to minimize restrictions, and will facilitate initiatives for international cooperation on anti-trust policies. In general, its creation will facilitate formulating policies which countervail the economic power of foreign-controlled oligopolists.

iv. Economic Efficiency

1. The size of the net economic benefit to Canada from foreign direct investment depends critically on whether foreign factors of production are used efficiently in Canada and on whether the quality of Canadian factors of production is high so that foreign firms operate in an environment of efficient performance by domestic firms. Without an appropriate set of industrial policies which create an efficient structure of industry in Canada, the benefits of foreign direct investment tend to be emasculated.

2. It is recommended that steps be taken by the Department of Industry to continue to provide leadership and planning in rationalizing Canadian industries, as through the encouragement of mergers of existing sub-optimal firms and the rationalization of the tariff. The anti-combines legislation should explicitly allow for this activity, though it should continue to apply to industries rationalized under government auspices so as to ensure public benefit. The government, where it aids in the financing, should participate in the equity. It is recommended below (see Canadian Participation) that the Canada Development Corporation

be created so as to increase Canadian participation in Canadian economic activity; the Canada Development Corporation could aid in the financing of industrial rationalization programmes through merger and could, via equity participation, provide a Canadian presence in those cases where the industry is largely foreign-controlled.

3. It is recommended that steps be taken to improve the quality of Canadian factors of production:

(a) Take all possible steps at the federal level to improve management education and training in Canada.

(b) Encourage Research and Development in Canada; specifically, strengthen the links between government, university, and industry research, ensure Canadian benefits from government-subsidized R & D as by prohibitions on export restrictions, and use some government funds for purely Canadian initiatives.

(c) Take steps to improve the position of the closed-end funds so that they will become more effective vehicles for the

exercise of Canadian entrepreneurship. Such steps could include permitting the funds to buy in their own stocks under certain controlled conditions, and the right, if they so elect, to declare and distribute their capital gains without special penalty.

(d) The Canada Development Corporation should be a catalyst to encourage private consortia.

4. It is recommended that the government should continue to promote multilateral tariff reduction in the interest of the overall efficiency of the Canadian economy in the allocation of productive factors and in order to facilitate the access of Canadian industry to export markets. At the same time, the government should take special steps, when there are agreements to rationalize industries or encourage mergers, to limit any tendencies under free trade for the locus of private decision-making to shift outside Canada and for overall Canadian employment to suffer in the short-run and the long-run.

v. Extraterritoriality

1. It is necessary, if Canada's sovereignty is not to be eroded and its national independence diminished, that positive steps be taken to block the intrusion into Canada of United States law and policy applicable to American-owned subsidiaries with respect to freedom to export to Communist countries, anti-trust law and policy, and balance of payments policy.

2. It is recommended that, with respect to United States restrictions on the freedom of its Canadian subsidiaries to export, a government export trade agency be created with the necessary powers to ensure that export orders are filled when they conform with Canadian law and Canadian foreign policy. State trading organizations of Communist countries could register orders placed with Canadian firms with the agency. Where an American subsidiary refused to fill a bona fide order placed with it, the agency would assist in having the order placed with a Canadian-owned firm or a firm owned overseas. Where no such firm could fill the order, the American subsidiary would be required to show cause to the agency. If the agency judges the sole inhibition to be

American foreign assets control regulations, the agency would purchase the item on its account for resale to the state trading organization, with supporting legislation making it a criminal offense for a firm to refuse to sell to the agency at existing market prices. A significant by-product of the agency would be the availability of full information to the Canadian government of export possibilities that would otherwise go by default. The agency should conduct its affairs in such a way as to keep the Canadian public fully informed; short of publicity on an on-going basis, cases dealt with by the agency should be reported to the public _ex post facto_. The agency might also undertake an active export promotion campaign with state trading organizations of Communist countries, coupled with assurances that export orders would be filled.

3. It is recommended that three specific steps be taken to block the intrusion of foreign anti-trust law into Canada:

(a) Legislate to prohibit the removal of commercial records and data from

business concerns within federal jurisdiction by reason of a foreign court order.

(b) Use the guiding principles questionnaire to elicit information on the operational impact of foreign anti-trust legislation on the Canadian subsidiaries of foreign corporations.

(c) Enact legislation to prohibit Canadian compliance with foreign anti-trust orders, decrees or judgments.

4. It is recommended that American balance of payments guidelines, controls, and surveillance machinery, insofar as they affect the behaviour of American-controlled subsidiaries in Canada, be countervailed by Canadian guidelines of an operational nature to foreign-owned subsidiaries and by the requisite surveillance machinery. It has been recommended above that the Canadian guiding principles questionnaire become mandatory. It must be centrally concerned with collecting information on export and import performance and capital transactions of foreign-owned subsidiaries. It is further recommended that

Canadian economic policy give explicit attention to how the growth of the Canadian economy can be maintained in the event of a lower inflow of American direct investment than would otherwise have taken place. The increasing stringency of American balance of payments policy gives urgency to the recommendations to improve the quality of Canadian factors of production and the efficiency of their use, and to create the Canada Development Corporation, so as to enhance the capacity of the Canadian economy to grow with relatively less foreign direct investment.

vi. Canadian Participation

1. Foreign ownership and control are not only pervasive in Canada but are likely to remain so. There is a need to ensure Canadian participation in the benefits of foreign direct investment and a Canadian presence in the decision-making of multi-national enterprises.

2. It is recommended that the Canadian tax system be used as effectively as possible to maximize benefits for Canadians from foreign direct investment. It has been recommended above that the special agency examine taxation procedures on an on-going basis to ensure that Canada gets its proper share of taxes paid by multi-national firms. Furthermore, it is recommended that Canadian tax authorities exercise caution in granting special tax arrangements to industries predominantly consisting of foreign-owned firms.

3. It is recommended that the Canada Development Corporation be created as a large holding company with entrepreneurial and management functions to assume a leadership role in Canada's business and financial community in close cooperation with existing institutions. It would have the capacity

to draw on the expertise of the financial community and to provide a focal point for the mobilization of entrepreneurial capital. Its size and its quasi-public character would enable it to make a unique contribution in organizing consortia of investors, domestic and foreign, thereby carrying out large projects beyond the capacity of a single institution and throughout maintaining a clear Canadian presence. The C.D.C. should be permitted and encouraged to be active in all sectors of the economy. Without limiting the generality of its operations, it should specifically be active in the areas of resource development and the rationalization of Canadian industry.

4. It is recommended that stronger incentives be considered to encourage large corporations, including foreign-owned subsidiaries, to offer their shares to Canadians, thereby increasing the supply of Canadian equities, facilitating disclosure, and providing levers for public regulation and for dealing with extraterritoriality. There are costs as well as benefits to this recommendation. For this reason, the use of Canadian capital for purely Canadian private ventures or for the Canada Development Corporation

is preferable to its use for buying minority holdings in foreign-controlled subsidiaries to the extent that other recommendations for obtaining disclosure and dealing with extraterritoriality are implemented.

vii. Conclusion

1. Each of these proposals should be considered on its own merits, and all do not require implementation at the same point of time. But these proposals, taken as a whole, are designed to be a comprehensive program which deals with foreign ownership in a way that is both economically and politically realistic and is in Canada's long-run national interest.

CONCLUSION

i. A New National Policy

1. The old National Policy served Canada in its day, as an instrument of nation-building and a means of facilitating economic growth. The challenges have changed and a new National Policy is required. The nation has been built, but its sovereignty must be protected and its independence maintained. A diversified economy has been created, but its efficiency must be improved and its capacity for autonomous growth increased.

2. It is this spirit which informs the present proposals. While each individual proposal deserves careful consideration, taken together, these proposals are designed as a program which is realistic and attainable both from an economic and political viewpoint. Increased economic interdependence among nations is recognized, but also that a stronger national economy is needed to function effectively in a global setting. The movement within Canada toward stronger provincial authority is also recognized, but this does not alter the fact

that foreign ownership is a national issue that goes beyond regional concerns. The growing mutual dependence of nations today suggests finally that Canada's foreign policy and global responsibilities can be made more effective by sustaining a healthy national independence.

VII APPENDIX

i. Glossary of Terms

1. Definitions and statistics have been taken, to the extent possible, verbatim from the publications of the Dominion of Statistics.

Foreign Capital

2. For purposes of this Report, the term "foreign capital" applies to all long-term investments in a country by non-residents. At the end of 1964, foreign capital invested in Canada by type of assets included:

	(in millions of dollars)
Bonds and debentures:	
Government and municipal	4,682
Railways	509
Other corporations	3,056
Sub-total	8,247
Capital stock of Canadian companies	12,655
Net assets of unincorporated branches and other long-term investments	4,373
Income accumulating investment funds	42
Miscellaneous investments	2,037
Total foreign capital investments	27,354

Capital stock and net assets are measured in terms of book values; in a rising market, these can be well below market values.

Direct and Portfolio Investment

3. Investments of foreign capital in Canada may be classified into two main categories - direct investments and portfolio investments. The distinction arises chiefly out of the nature of ownership. A third category, miscellaneous, includes a group of investments which resemble direct and portfolio investments.

4. The essential distinction between direct and portfolio investment is that legal control of the asset is involved in direct investment. Foreign direct investment, therefore, represents capital investment in a branch plant or subsidiary corporation abroad where the investor has voting control of the concern. The Dominion Bureau of Statistics includes in direct investment . . .

> ".. all concerns in Canada which are known to have 50% or more of their voting stock held in one country outside Canada. In addition, a few instances of concerns are included where it is known that effective control is held by a parent firm with less than 50% of the stock. In effect, this category includes all known cases of unincorporated branches of foreign companies in Canada and all wholly-owned subsidiaries, together with a number of concerns with a parent company outside of Canada which holds less than all of the capital stock. In addition, there are a relatively small number of Canadian companies included in cases where more than one-half of their

capital stock is owned in a single country outside of Canada where there is not a parent concern."

5. There is a difference between the legal position of effective control of voting stock and the extent to which that control is in fact exercised. The word "control" is a convenient short way to refer to the legal position, but statistics on stock-ownership do not in themselves indicate the extent to which the officers of the major shareholder abroad do in fact exercise their influence.

6. At the end of 1964, direct investment in Canada by type of asset included:

	(in millions of dollars)
Bonds and debentures:	
Railways	3
Other corporations	1,567
Capital stock of Canadian companies	10,232
Net assets of unincorporated branches and other long-term investments	4,087
Total direct investments	15,889

7. Foreign portfolio investment is involved where the form of the investment (in bonds and loans) or the amount (in voting stock) does not involve legal control of the asset. The Dominion Bureau of Statisti

includes in portfolio investment

> "... scattered minority holdings of securities which do not carry with them control of the enterprises in which the investments occur. Usually securities are public issues such as bonds and debentures of governments, municipalities, and corporations and the stock of companies listed on stock exchanges, although less marketable issues may also constitute some parts of this type of investment."

8. At the end of 1964, portfolio investment in Canada by type of asset included:

	(in millions of dollars)
Government and municipal bonds	4,682
Other portfolio investments:	
Bonds and debentures:	
Railways	506
Other corporations	1,489
Capital stock of Canadian companies	2,423
Net assets of unincorporated branches and other long-term investments	286
Income accumulating investment funds	42
Total portfolio investments	9,428

Foreign Ownership and Control Ratios

9. Foreign ownership ratios measure equity and debt capital owned by non-residents as a percentage of total capital employed in the industries. Foreign control ratios measure equity and debt capital invested by residents as well as non-residents in those companies whose voting stock is controlled by non-residents, all of which is taken as a percentage of the total capital employed in the industries. For any industry, to the extent to which residents invest in companies controlled by non-residents, the foreign control ratio will exceed the foreign ownership ratio. Conversely, to the extent that non-residents invest in resident-controlled companies in any industry, the foreign ownership ratio will exceed the foreign control ratio.

10. The extent of non-resident ownership and control in general, and of American ownership and control in particular, in various sectors of the Canadian economy for various years is evident from the following table:

Industry

Percentage of total owned or controlled by all non-residents	Non-resident ownership			Non-resident control		
	1926	1948	1963	1926	1948	1963
Manufacturing	38	42	54	35	43	60
Petroleum and natural gas	-	-	64	-	-	74
Mining and smelting	37	39	62	38	40	59
Railways	55	45	23	3	3	2
Other utilities	32	20	13	20	24	4
Total of above industries and merchandising	37	32	35	17	25	34

Percentage of total owned or controlled by U.S. residents	Non-resident ownership			Non-resident control		
	1926	1948	1963	1926	1948	1963
Manufacturing	30	35	44	30	39	46
Petroleum and natural gas	-	-	54	-	-	62
Mining and smelting	28	32	54	32	37	52
Railways	15	21	9	3	3	2
Other utilities	23	16	23	20	24	4
Total of above industries and merchandising	19	23	28	15	22	27

Multi-national Corporation

11. A multi-national corporation is a corporation which engages in foreign direct investment. It is the parent corporation which controls one or more incorporated subsidiaries and/or one or more unincorporated branches abroad.

Host Country

12. A host country is a country which receives foreign direct investment.

Use of Foreign Resources and Direct Foreign Financing of Investment

13. Measurement of the extent to which non-residents have financed total public and private domestic investment can be done in two ways. The first approach attempts to measure the net contribution of non-residents to the savings used for all types of physical investment in Canada or, expressed differently, the extent to which Canada has drawn on or added to the resources of other countries. The second approach is concerned with the extent to which foreign capital has directly financed Canadian investment, disregarding outflows of Canadian capital to participate in investment

abroad and the return of non-resident capital formerly brought to Canada. In each approach, it is of interest to ask the extent to which non-residents have financed both gross and net investment, the significance of the latter comparison lying partly in the fact that new financing may be regarded as being substantially for additions to the stock of capital rather than for its replacement. Estimates for these two measures for various time periods are as follows:

Foreign Financing of All Canadian Investment, 1946-65

Measure	1926 -30	1946 -49	1950 -53	1954 -57	1958 -61	1962 -65
	percentages					
Use of foreign resources as a percentage of:						
gross capital formation	-	-	14	26	27	20
net capital formation	25	-9	14	32	34	19
Direct foreign financing of:						
gross capital formation	-	19	23	31	33	33
net capital formation	50	24	29	43	47	43

Oligopoly

14. Oligopoly refers to an industry in which there are only a few sellers, so that the activities of each firm would have an appreciable effect on market price. Because of the latter, there is a tendency for the firms to avoid price competition and, to the extent they compete, to engage in non-price competition. An important type of non-price competition is where the firms produce "differentiated products", that is, a more or less similar product differentiated by sales promotion techniques such as brand names and advertising.

Industrial Concentration

15. Industrial concentration refers to the degree to which output in an industry is concentrated in a few firms, that is, the extent to which a small number of firms dominate an industry. The concentration ratio is a numerical measure of industrial concentration based on the percentage of an industry's sales or employment, or value of shipments, accounted for by some given number of firms - such as 4, 8, 9, or 20. The importance of foreign control in accounting for concentration can be measured by the number of foreign-controlled firms among the largest firms, or by their percentage of industry sales.

16. The relationship between concentration and foreign control is shown in the following table. Concentration ratios, without respect to the nationality of ownership, are given for the largest 8 firms and the largest 20 firms at the level of 19 two-digit industry groups. The importance of foreign control is measured among the largest 20 firms in terms both of the number of foreign-controlled firms and their percentage of industry sales. Using tabulations from CALURA, the relationship was as follows in 1964:

Industry Group	Sales $ Million	Percentage of Sales in Largest 20 Firms	Foreign-Controlled Firms among Largest 20		Percentage of Sales in Largest 8 Firms
			Number	Percentage of Industry Group Sales	
Food	5101	40	11	15	28
Beverages	860	89	8	15	80
Tobacco	412	100	16	81	78
Rubber	534	94	13	88	80
Leather	269	44	7	16	28
Textiles	2042	34	9	18	26
Wood	1125	34	7	17	27
Furniture	272	33	4	10	20
Paper	2886	57	7	17	50
Printing	719	47	1	n.a.	27

Industry Group	Sales $ Million	Percentage of Sales in Largest 20 Firms	Foreign-Controlled Firms among Largest 20		Percentage of Sales in Largest 8 Firms
			Number	Percentage of Industry Group Sales	
Primary Metals	2931	86	10	43	71
Metal Febricating	1730	33	12	21	25
Machinery	1510	47	16	34	36
Transportation Equipment	3251	79	15	75	68
Electrical	1887	66	14	40	53
Non Metallic Minerals	790	53	14	32	33
Petroleum and Coal Products	2460	99	18	n.a.	93
Chemicals	1935	52	17	41	32
Miscellaneous Manufactures	642	39	13	29	26